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To

Dr. Sir. Purshotamdas Thakurdas,
K. B. E., C. I. E., M. B. E., J. P., D. Litt.

This book
is dedicated as a token of
deep respect and gratitude by



Author

MONEY, CREDIT & FOREIGN EXCHANGE

With
Special Reference to India

By
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FOREWORD.

The problems of Currency, Banking and Exchange in the post-war period have been engaging the attention of financial and economic experts all over the world. Before 1914 when the world conditions were more or less normal, gold standard with its inflexible rates of exchange came to be regarded as the only monetary standard, which made for permanence and automatism. So great was the faith placed in the stability and smooth working of the gold standard, that after the First World War most countries took the earliest opportunity of reverting to gold standard, which remained in suspension during the War.

The World Economic Depression and its aftermath however unmistakably demonstrated the unsuitability of the standard to withstand the stress and strain of economic disequilibrium. Since then there have been many experimentations and new monetary methods and practices have been evolved with varying degrees of success.

With the approaching end of the war in the west the thoughts of the world are now centred round the organisation of peace and rehabilitation of normal economic life of the warring countries. The question of national and international monetary standard, rates of exchange, national and international banking policy, the settlement of normal trade balances—these and other problems await an agreed solution. The commercial and industrial development of India will be conditioned to a large extent by a satisfactory solution of her monetary and exchange problems and an equitable settlement of the so called "abnormal war balances."

For a proper understanding of all these problems, it is necessary that our students of Commerce and Economics should have a good grinding in the principles and problems of currency and exchange. What few good books there are on these subjects are generally beyond the reach of the

average student in our colleges and universities. It is therefore with great pleasure that I welcome "Money, Credit & Foreign Exchange", which has just been brought out by Mr. P. D. Saksena M. A., B. Com., L. T. Lecturer, K. P. College Allahabad.

I have gone through some chapters of the book, which Mr. Saksena was good enough to show me before the final proofs were sent to the press. The book bears ample evidence of hard work, wide reading, lucid exposition and scientific presentation. Mr. Saksena has made every effort to compress in his book a mass of information on particularly every topic which is likely to be of interest to the average student of Currency and Exchange. I am sure the book will prove very useful to those for whom it is intended.

B. N. Chatterji M. A. B. L.,

Dean,

Faculty of Commerce

Lucknow University,

Lucknow

April 1, 1945

versity, Lucknow, for his learned foreword which has immensely increased the usefulness of the book.

The author will be extremely obliged to receive constructive criticisms and suggestions conducive to the improvement of the book, and expresses his regret for a few mis-prints which have found their way in this edition.

K. P. College,
Allahabad,
April 1, 1945.

P. D. Saksena.

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CHAPTER I

MONEY

Origin and Early History

In early stages of economic life man lived in hordes and carried on hunting, fishing and collection of wild fruits to satisfy his economic wants. He ate meat, fish or fruits so obtained alone or by sharing them with other members of his family or horde. Later on he found that it would be to his advantage to exchange some portion of the commodity which he possessed more than sufficient, for another which his neighbour had in excess. It could certainly not have been long before the primitive man must have discovered the benefit of offering some of his surplus meat or fish in exchange for the surplus milk, fruits or wool of another person. Thus business was effected by a direct transfer of commodities, and there was neither money nor any other medium of exchange. This direct exchange of commodities, one for the other, is termed as barter and survives even today amongst the savage tribes of West-Africa, Brazil, etc.

In course of time with the increase in the number of exchangeable commodities and the number of times that they exchanged, the difficulties and inconveniences of the barter system of exchange became obvious. In barter system every person is buyer and seller at the same time. It involves the satisfaction of wants of both the parties to the bargain i.e., it requires that one man must need what the other can spare, and that he must give what the other happens to want. The difficulties and inconveniences attending this double coincidence of wants must have become evident to the people even in the simple conditions of primitive life. For example a person may desire to exchange his fruits for skins, but the other person with skins to spare may require salt in exchange and not fruits. Thus the exchange cannot take place for it can not satisfy both the parties. Under barter system the exchange of services is all the more difficult than the

could serve the purposes of money in the best possible manner. Thus gold and silver pieces of varying weight, fineness, and size began to be used as money or medium of exchange of other commodities and services, and there are records to show that these metals were familiar as standards of value and mediums of exchange to the Indians, Assyrians, Babylonians, and Phoenicians. In the beginning gold or silver pieces offered as price were weighed and tested in every transaction in which they were used. Gradually people began to shape them into rings, discs, bars, etc., so that the difficulty of weighing and testing them every time they were used might be avoided. Still the difficulty was not removed for some clever men could easily clip off a portion of the metal or reduce its quality by adulteration of some inferior metal. Hence people were compelled to make coins of these metals of a standard weight, size and purity. The earliest coinage of money is usually attributed to the Greeks. Later on other countries also adopted a system of suitable coinage. Today we see that in almost all the advanced countries of the world there is not only in use metallic money but a large amount of paper money as well.

Importance of Money

Books of all times and all countries have numerous references of the use and abuse of money, and show how closely economic development of a country is related to the system of exchange in use in that country. The monetary system of a country is adapted to the stage of industrial and commercial life reached by her people. The higher is the stage of economic life of the people of a country, the more developed is the system of its money and exchange. The barter system of exchange is impossible except only under very primitive conditions of society. There as well it involves many difficulties and inconveniences. In barter commodities exchange for commodities. Thus under this system if a person wants to dispose off his surplus commodity, he is required to find out a person who may be in need of his commodity and at the same time must have that commodity to spare which he himself requires. Very often it is a difficult task.

In case of money system of exchange every body sells and purchases through money. Thus a person, who wants to dispose off his surplus is required to find out a person who is simply in need of his surplus commodity and has the power of purchasing it. Money has the general power of purchasing all the other commodities and enables its holder to make his purchases in the form and at the time which suit him best. Consequently nobody hesitates in accepting it in exchange of the commodity that he sells for he knows that with its help he can obtain any other commodity that he may desire to have. Moreover owing to its constant use people are able to recognise and assess the value of money very easily and quickly. On the other hand in barter system it becomes necessary for every person to be able to recognise and assess correctly the values of all other commodities that may possibly be offered to him in exchange of his own. This is almost an impossible task. Money provides a common standard for measuring the values of all other commodities. Hence it facilitates the formation of a correct estimate of the relative values of other commodities. These facilities offered by money lead to a greater and more rapid development of trade commerce and industry than would be possible without it.

Further it should be noted that barter does not offer any common medium through which all other commodities may be exchanged. Commodities are exchanged directly with the other commodities. Thus every seller has to accept in exchange of his commodity the various commodities of others. Various commodities differ in their portability, durability, divisibility, and stability of value. Many commodities are very bulky or heavy as compared to their value. They can not be taken from one place to another easily and their carriage is very expensive. Thus in barter unless a person wants a commodity for his own consumption he would not accept it in exchange of his own, if that commodity be not easily portable for the expense of transporting that commodity from one place to another for purposes of exchange will cost him a great deal. On the other hand generally money is a very portable commodity, and therefore people do not hesitate

in accepting it from others in exchange of their commodities for they know that they can take it to any place they like quite easily and cheaply.

Certain commodities are highly perishable. They lose their value very soon, and as such people naturally hesitate in accepting them in exchange of their own unless they need them for their immediate consumption. On the other hand generally the money material is very durable, and therefore people have no hesitation in accepting it even if they do not require it for being used immediately or in the near future. Further it should be noted that many commodities are indivisible, and as such in exchanging them for commodities of smaller value under the barter system, there arises a considerable difficulty. For example suppose a person has a goat and needs a seer of salt. The transaction can not take place unless the owner of the goat is prepared either to take a larger quantity of salt or lose a large portion of the value of his goat. In both cases it would not be a fair exchange. On the other hand money is generally divisible, and thus can conveniently exchange for commodities of even extremely low value. Moreover usually money is also such a commodity which can conveniently be combined together after it has once been divided.

Another point worth noting is that the exchange values of many commodities do not remain sufficiently stable. The exchange value of a commodity depends upon its demand and supply. Comparatively demand and supply of other commodities fluctuate more widely from season to season than that of money. The exchange value or the purchasing power of money, though not absolutely stable, yet remains more stable than the values of most of the other commodities. Sometimes people sell their surplus products not with a view to spend their purchasing power received in obtaining other commodities at once, but in order to store it and use it in future when they require certain articles for consumption. For this reason they want to dispose off their surplus commodities in exchange of some such commodity which they can conveniently store and whose value will not depreciate

much in future. Money fulfils these purposes in a much better manner than any other commodity in the world and therefore its use encourages the exchange of commodities or trade

It should be noted that ours is the age of credit. Most of the large scale business concerns are working successfully today due to the various credit facilities that they enjoy. The basis of all credit is money. Without a suitable money and a systematic evolution of credit based thereon the modern large scale business would have been a dream and an impossibility. The entire business of banks is to deal in credit or the use of money for temporary periods of time. Consequently without the use of money no country could boast of any large scale business or a successful banking organisation. Thus in view of the numerous difficulties enumerated above it should be noted that without the use of money trade commerce and industry would not develop at any large scale.

There is no doubt that ultimately all trade and commerce is in effect protracted barter and no country can consume more than what it produces. But for the proper exchange of goods to suit the convenience of both the buyers and sellers of various commodities it is essential that there should be a common standard of value and a common medium of exchange of all other commodities. If there is no such standard of value or medium of exchange trade commerce and industry would be extremely hampered. It would not be possible to organise them on such a large scale as of today. The present day organisation of various forms of productive and distributive businesses on large scales has been rendered possible also by the use of a convenient form of money. Truly speaking our entire civilisation consists of a money system and depends upon the suitability and efficiency of that system. Industry, trade, commerce, banking or the entire productive machinery on which rests the satisfaction of the fundamental needs of modern life, depends upon the existence and proper handling

of a scientific monetary policy. "An institution like that of money, which has in our times helped and stimulated production and has offered to society the means of guaranteeing to every member the physical requirements of life, releasing his energies for creative work, for social service, for the furtherance of the spiritual potentialities of human life, needs to be carefully guarded and preserved, instead of being abolished; but it also needs to be purified of the evils which have incidentally resulted from its being regarded as an end in itself, instead of as a means to an end." ¹

Money has enabled the study of the science of Economics much easier than otherwise would have been possible. At present most of the economic tendencies and their results are expressed in terms of money. Peoples' desire for other goods and their power to acquire them find expression in terms of money. National dividedness, wages, rent, interest, profit, production, consumption, cost of living, internal and international trade, state aid or protection to different industries or trades, etc., are all expressed in terms of money and thereby make their individualistic and comparative study very convenient. In brief all human efforts, activities and interests in modern times gravitate round money. Even the standing of our modern artists, poets, dramatists, writers, editors, teachers, scholars, politicians etc., is determined by the money value of their services and the price paid for their work. It is possible to do all this for money acts as a common standard of exchange values of all other commodities, services, efforts, etc.

Definition of Money

To give a formal definition of money is difficult for the reason, that it performs such a large variety of functions, that if an attempt be made to incorporate all those functions in the said definition, it would become so lengthy and loose that it would lose almost all the force of its being clear and exact. Sometimes the word money is used in a very broad

¹ Money and the Money Market in India by P. A. Wadia and G. H. Jerhi, pp. 2 and 3.

sense and means anything which is used and accepted as a means of exchange such as money made of gold and silver; paper money like bank notes and notes issued by the government, and bills of exchange, promissory notes and cheques, which are though not generally acceptable yet sometimes have a limited circulation. On the other hand sometimes the word money is used in a very narrow sense and means only metallic money of gold, silver, copper, etc., because it has a value based on its direct use for consumption. Gold, silver, copper, brass, etc., have an intrinsic value due to their being demanded also for purposes other than the monetary ones. Thus sometimes paper money is not regarded as money because it has very little or no intrinsic value at all. Both of these views are incorrect. Common usage is against using the word money to mean bills of exchange, promissory notes, cheques etc., or only metallic money of gold, silver, bronze, etc., and not also paper money issued by the government or the central bank of a country.

Properly speaking money should be used to mean all those media of exchange whether metallic pieces or notes issued by the government or the central bank, which are generally acceptable and pass freely from hand to hand even amongst strangers in a country. In this sense in India money would include metallic money of silver, nickel, bronze, and copper and the paper notes issued by the Reserve Bank of India as well as currency notes of the Government of India so long as all of them are not finally withdrawn and cancelled. Similarly in England money means coins of gold, silver, nickel, and copper and the Bank of England notes.

Thus money of a country can suitably be defined as a commodity or commodities chosen by its people, whose different units act as means of reckoning relative values and medium of exchange of different quantities of different commodities and services, and in doing so pass freely from hand to hand without any reference to the personal credit of the parties concerned in the various exchange transactions. This shows that the chief characteristics of money of a country

are (a) it acts as a common measure of expressing the exchange values of all other commodities and services of the country; (b) it acts as a common medium of exchange of all other commodities and services of the country; (c) it passes from hand to hand freely i. e., without any reference to the personal credit of the parties concerned; and (d) it can legally be forced upon other people of the country in final settlement of pecuniary obligations or payments of exchange values. This shows that though there may be many forms of money in any country, yet the idea underlying all of them is that they can legally be used both immediately and in future to command in exchange the labour or the product of labour of others. Thus money of a country has the general power of purchasing all other commodities and services of that country. "Money is a kind of claim upon all other members of the community; a sort of order or promise to deliver which can be enforced whenever the owner pleases. It is a means to an end, held temporarily, not for its own sake, but as a means of obtaining other articles or of commanding the services of others."¹ It is in this sense that Cole defines money as 'Money is what buys things—purchasing power.'²

Functions of Money .

In the foregoing pages relating to the origin, history and importance of the use of money, it must have been noticed that there are two very important functions which money of every country has to perform. Firstly it acts as a common measure or standard of exchange values of all the commodities and services of a country. Secondly it acts as a common medium of exchange of all those commodities and services. Besides these two offices money of every country has to perform a few other functions such as a standard of deferred payments and means of storage of value. Let us now briefly examine the various functions and services performed by money in order to arrive at a clear understanding of its activities.

(1) In the first place money serves as a common denomi-

1. Elements of Economics by S. Evelyn Thomas, page 400.

2. What Everybody Wants to Know About Money by Cole.

nator or standard of exchange values of all other commodities and services of a country. (These values in terms of money are known as prices. By measuring the above values or prices money enables the owners of various commodities to form correct estimates of their comparative values.) Thereby people are enabled to find out easily and correctly the quantity of a certain commodity that they should give in exchange of a certain quantity of some other commodity.) This facilitates their exchange or trade and the people are encouraged to deal on a large scale. Thus trade, commerce and industry can be carried on conveniently on a large scale only when there is a common standard or unit to measure the values of other commodities and services. This common standard or unit is provided by money. Measurement of the value of one commodity in terms of thousands of others, indispensable in case of barter system, is an extremely difficult task if not an impossible one. This difficulty is still greater in the case of valuation of different services. Thus if there is no common standard services are discouraged and labour of different kinds can not be organised on any scientific or systematic basis. All these causes retard the growth of trade, commerce and industry, and in the absence of a common standard they can be carried on only on a small scale.

(2) Another very important function that money of every country has to perform is to act as a common means or medium of exchange of all other commodities and services. The barter system of exchange suffers from two very formidable difficulties viz., (a) the inconvenience arising from lack of coincidence of wants, and (b) the indivisibility of some of the goods. Money is acceptable to all and always. People who accept it in exchange know that it is intrinsically valuable. It is believed by all that money is a commodity for which there will always be a demand. Thus when people have confidence that money shall always be acceptable to all, they have no hesitation in taking it in exchange of their own surplus commodities. Moreover money is easily divisible and can be offered conveniently in exchange for even small quantities of other commodities. Consequently almost all

commodities and services of a country are sold and purchased for money and it acts as a common medium of their exchange. This function of money i. e., acting as a common medium of exchange is facilitated all the more due to the fact that at the same time it also acts as the common standard of exchange values of other commodities and services.

(3) Money is also used as a means of storage of value. This function of money has arisen out of the main characteristics that money possesses. It must have already been noted before that money is acceptable to all at all times. It is a commodity whose value does not fluctuate very much within short periods of time. There is no doubt that even the value of money does not remain absolutely fixed at all times. There are fluctuations in its value, but compared to all other commodities it is the only commodity whose value remains more or less constant over even long periods of time. Many people make savings for their old age and try to keep those savings in the form of money. They prefer money for this purpose for they know that not only it will always command a general power of purchasing all other commodities and services, but that its value also will not fluctuate much in the near future or within a reasonable period of time. On the other hand most of the other commodities do not possess a general power of purchasing and their values also do not remain sufficiently stable. Thus money is the most convenient and reliable form in which people can keep their savings or the fruits of their past labour; for it guarantees to every possessor of it a claim over society's goods, services and other physical requirements of life and through them a reasonable standard of living. For these various reasons one more important function that money has to perform is that it acts as a means of storage of value or general purchasing power.

(4) Money performs one more function. It acts also as a standard of deferred payments. With the development of economic life i.e., accumulation of capital and growth of public confidence, there arose also the necessity and possibility of taking loans of the surplus wealth of others in order to be

used for productive and unproductive purposes. Before the use of money these loans or credits were granted in the form of commodities, but like barter here also there were many difficulties from which both the creditor and the debtor suffered. The greatest difficulty in such transactions was the instability of the values of commodities lent or borrowed. Compared to the value of money the values of other commodities do not remain stable. They fluctuate from time to time very widely, for their demand and supply do not remain constant. The demand for and supply of ordinary commodities fluctuate from time to time more widely than the demand or supply of money. Thus comparatively the value of money remains more stable than the value of ordinary goods. Consequently both the persons who lend and the persons who borrow desire to do so in terms of such a commodity whose value will more or less remain the same at the time of lending or borrowing and its repayment. This is done with a view that neither party may suffer on account of a change in the value of the commodity which is lent or borrowed. This led to the use of money for giving or taking loans and the determination of the price to be charged for the use of that money or interest.

In modern business a large number of sales and purchases are effected on credit and they involve deferred payments. These are promises that the said payments would be made after some time from the dates of those transactions. A promise in exchange of which certain goods or services are given by one person to another should retain the same purchasing power on the date of final payment, which it had on the date on which it was made. Consequently it is necessary that from the beginning the above promise should convey a definite idea of its value on both the above dates i.e., the date on which it is made and the date on which it is fulfilled. This is best provided by the relative stability of the value of money. Therefore, money serves at present as the best standard of deferred payments and it is one of its most important functions today.

It should be noted that money at present does not only act as a standard of deferred payments, but that it also forms the main basis of the entire credit structure of the modern business world. All promises to pay in future for the goods purchased or services received are ultimately redeemed or paid for in terms of money. There is no doubt that some of these promises or credits are cancelled against each other and money is not used in their settlement. But, it must be remembered that most of these cancellations are not made directly but in an indirect manner i.e., through the intervention of a third party or parties. For example suppose A purchases certain goods on credit from B, B purchases on credit certain goods of the same value from C, and C on his turn purchases certain goods of the same value on credit from A. In these transactions no cash or money may be used between the parties and final settlement may be made by mere cancellation of the mutual credits involved. But it must not be forgotten that even these transactions involving credits or promises to pay in future have money as their main basis or a factor in whose terms all their future claims are determined and finally settled. Thus in modern society money also serves as the main basis and medium of all development of credit. The four functions of money can easily be remembered by the following rhyme :—

"Money's matter of functions four,
A medium, a measure, a standard, a store."

Money and Currency

The term 'currency' is often used as a synonym of the word 'money'. Currency is derived from the word 'current' and precisely speaking means all the current units of monetary system of a country. All forms or units of money of a country which are current at any time or which can legally be forced upon others in payment of exchange values or prices are known as currency. For example at present in India Government of India one-rupee notes, notes issued by the Reserve Bank of India, quarternary rupees, etc., can be termed as currency; while all the old notes issued by the Government of India

and silver rupees of the time of Edward VII, George V, etc., can be termed as money. All units of currency of a country are money, while all units of money of a country at any time may not be its currency. Thus currency is only a part of money of a country and means all those units of money of the country which are legally current in use and for whose acceptance in payment no person in that country can have any legal excuse or objection.

Questions

1. What is barter system of exchange? What are its main difficulties? How does the use of money remove the main difficulties of barter? Explain.
2. 'The present is said to be the age of money economy.' Why is it so? Justify the truth of the statement.
3. 'All men love money.' Why? Explain.
4. Define money. What functions are performed by money in modern times? Explain.
5. 'The modern large scale trade, industry and commerce would have been a dream and an impossibility without a suitable money.' Comment on the statement.

CHAPTER II

THE QUALITIES OF A GOOD MONEY MATERIAL

In the previous pages we have studied that money has to perform various important functions. For example it has to act as a standard of values and medium of exchange of other commodities. It has to act also as a standard of deferred payments and a means of storage of value. There is no doubt that with the growth of banking and credit the last function of money is losing its importance except that the values of all stores of wealth are expressed in terms of money. To perform these various functions efficiently and cheaply it is necessary that the material of which the money of a country be made should have a number of qualities. Some of the important qualities of a good money material are given below:—

- (1) General Acceptability, Utility or Value.

- (2) Stability of Value,
- (3) Durability,
- (4) Portability or large value in small weight and bulk,
- (5) Divisibility and Homogeneity,
- (6) Aggregatability,
- (7) Cognisability, and
- (8) Malleability.

(1) *General Acceptability, Utility or Value*—This means that the material of which the money of a country be made should be generally acceptable to all people *i. e.*, people should have no hesitation in taking it in exchange even from strangers. This requires that the money material should intrinsically possess utility and be valuable. It must have a value other than that conferred upon it by law or government of the country by making it money. It must possess an intrinsic value of its own equal to its value as money. It must be a commodity for which there is always a general demand and which permanently commands an exchange value. If the money of a country is made of such a material, people have no hesitation in taking it in exchange of their commodities and services, for they know that their money will always enable them to get other things not only within the country but everywhere. This facilitates trade and commerce and people buy and sell goods and services quite freely. On the other hand if the material of which the money of a country is made is not intrinsically valuable and thereby not generally acceptable, it does not find free circulation. It does not act as a good medium of exchange and trade and commerce are hampered.

There is no doubt that some forms or units of money *e.g.*, currency notes issued by the central banks or governments of many countries are not intrinsically valuable, still they pass freely from hand to hand and act as quite good money. It should be noted that such forms of money find general acceptability only in countries in which they are issued. They carry with them a promise of a reliable party such as the government or the central bank of the country to redeem or

convert them at the will of the holder into something which is intrinsically valuable. So long as the currency systems of different countries were not so well organised as to command enough confidence of their people, these forms of money were not popular. They had only a limited local circulation. Gradually the currency authorities of the different countries became so well organised and began to command so much confidence of the people that these forms of money, though not made of materials intrinsically valuable, yet are used quite freely but only in their own countries of issue. Such forms of money have not as yet on international free circulation, though gold and silver coins are universally acceptable of their intrinsic worth. The main reason of this is that as yet international confidence is not sufficiently developed.

Sometimes the forms of money which are not intrinsically valuable do not find a general acceptability and free circulation in their own countries of issue for the reason that peoples' confidence in the currency authorities of their country is shaken due to some disturbed political conditions or on excess of such forms of money and consequently difficulties of their conversion into such moneys which are intrinsically valuable. In the second decade of the present century the Government of India put in circulation One-Rupee and Two-and-a-half-Rupee Notes and nickel Eight-anna bits. People of the rural areas who form an over-whelming majority in this country hesitated in accepting these forms of money. They circulated at a discount and did not act as good money. Ultimately they were withdrawn from circulation by the Government. In the beginning of the present war also there was a great hesitation on the part of the people in accepting the newly circulated One-Rupee Notes. Thus we see that in order to do its work efficiently, it is necessary that the money of a country should be made of a material which is intrinsically valuable, and that the face or fiduciary value of the money should be equal to its intrinsic value. The Indian Rupee is defective in this sense. Its intrinsic value is much less than its face or fiduciary value. It is like a note printed on silver

instead of paper and carries with it all the disadvantages that appertain to such a form of money.

(2) *Stability*—In the second place it is necessary that the exchange value of the material of which money be made should be stable. By stability of value is meant comparative fixity over reasonably long periods of time. Absolute stability is neither possible nor even desirable, but it is essential that with the passage of time the value of the money material should remain more or less the same. We have already seen that money has to act as a means of storage of value and a standard of deferred payments. People will certainly not like to store that form of money the value of whose material may fluctuate from time to time very widely. Thus it will discourage the accumulation of capital and thereby trade and industry would be hampered.

Uncertainty of the value of money due to fluctuations of the value of its material will also discourage credit, which is an essential and indispensable factor of modern business. Usually credits are measured in terms of money. Both the value of a credit granted and the value of its repayment are expressed in terms of money. Values of all credits, whether verbal or documentary or cash or mercantile, are defined in terms of money. Every credit instrument specifies what amount was originally lent and what amount would be repayable after the agreed time and generally the medium of repayment of credit is also money. An important presumption of all credit dealings is that the value of money in whose terms credits granted would be repayable would remain stable. A debtor desires that at the time of repayment the value of money in whose terms he will have to repay should not be higher than what it was when the credit was originally granted to him. On the other hand every creditor's desire is that at the time of repayment of his loan the value of money in whose terms he will be repaid should not be comparatively lower. In case of the former the debtor will lose for he would be able to obtain the same amount of money, when its value has increased, with greater effort or in exchange of a larger quantity of goods than against which it could be obtained at

the time of taking the loan. In the latter case the creditor will lose, for due to a fall in its value at the time of repayment, the same amount of money would bring in exchange less of goods or services than which could be obtained for it at the time when the loan was given.

In case owing to the instability of the value of its material the value of money does not remain stable but changes quickly, sometimes the debtor will lose and sometimes the creditor will lose. In case the value of money comparatively rises, the debtor shall be in terms of purchasing power repaying much more than what he had originally borrowed. On the contrary if comparatively money value falls, the creditor would actually get less purchasing power than what he had originally lent. For example suppose A borrowed from B a sum of Rs 100/- at a time when the value of a rupee or its general purchasing power was X and returns it at a time when its value or general purchasing power becomes $X - \frac{X}{10}$. Thus ignoring interest which is really the price paid for the use of money, here the creditor B suffers a loss of $(X \times 100) - \{ 100 (X - \frac{X}{10}) \}$ or $10X$ due to a fall of the value of money. On the other hand if A borrows at a time when the value of a rupee is X and repays it at a time when its value has risen to $X + \frac{X}{10}$, he will lose $\{ 100(X + \frac{X}{10}) \} - (100 \times X)$ or $10X$, so far as repayment of only principal money is concerned. Thus instability of the value of money always causes an unearned loss either to one party or the other. This discourages credit dealings and consequently trade and industry do not develop on any large scale. Therefore stability of exchange value or general power of purchasing is an important quality of a good money material.

The yearly production of gold and silver as compared to their existing stocks in the world is so negligible that it has little effect on their market values. Thus different countries of the world have experienced that out of all gold and silver are the only materials whose demand as well as available quantities do not fluctuate very widely within short

periods of time, and therefore, their values or general purchasing powers remain more or less the same. For these reasons they are regarded as the best forms of money materials. The gold production of the world remains remarkably constant. There are about 25 million ounces mined every year. Silver is a contrast to gold. Thus between gold and silver history has shown that production of gold has been more stable than that of silver. Therefore value of gold has been comparatively more stable than that of silver. Consequently it is a better form of money material than silver. In view of these facts most of the advanced countries of the world have adopted gold for their standard money, while silver is used by them for making only their subsidiary currency. Indian money is as yet made of silver and if it is desired that her trade, industry and commerce should develop on sound lines and that she should also come at a par with the other advanced countries of the world, Indian money should also be either made of gold or linked with gold.

*Average Annual Production of Gold and Silver and
the Ratio of their Market Values.*

Period.			Gold in millions of fine ounces.	Silver in millions of fine ounces.	Ratio of market values in silver.
1701—1720	...	...	4	11'4	15'6
1721—1740	...	...	6	13'8	15'0
1741—1760	...	...	8	17'1	14'6
1761—1780	...	...	7	20'9	17'7
1781—1800	...	...	6	28'2	15'3
1801—1820	...	...	5	23'0	15'6
1821—1840	...	...	6	16'3	15'8
1841—1860	...	...	4'1	26'9	15'6
1861—1880	...	...	5'8	55'1	16'2
1881—1900	...	...	7'6	131'0	25'0
1901—1910	...	...	18'2	162'5	35'9
1911—1920	...	...	20'6	193'5	28'8
1921—1930	...	...	18'6	238'6	26'5
1931—1935	...	...	25'9	185'4	...
1936—1940	...	...	...	...	...
1941	...	...	41'0	268'0	...
1942	...	...	...	...	...
1943	...	...	...	...	...

Since 1933 there is an agreement between the important silver producing countries of the world to restrict the output of silver with the object of stabilising its price.

(3) *Durability*—An important function of money is also to help people in the storage of wealth or the power of purchasing other things. Wealth is stored with the object of being used in future in making purchases of other commodities when necessity may arise. Consequently people naturally prefer to keep as much of their wealth as possible in such a form which would help them in getting other commodities conveniently whenever they want to do so. We see that money is a commodity which all people at all times accept freely in exchange of their commodities. Hence people generally prefer to store as much of their wealth in the form of money as possible. Thus it is absolutely necessary that the material of which the money of a country be made should be such which can conveniently be stored, and which having been stored should not depreciate in value with the passage of time. This necessitates that the money material should be durable. For these reasons metals are better form of money materials than paper currency or vegetable commodities like wheat, rice, etc. Most of the metals also depreciate in value on account of rust. Gold and silver do not depreciate by rusting. "It has been estimated that a sovereign would take 8000 years to wear out completely. Silver coins are far less durable, but nevertheless they retain their lustre and are not subject to rust or tarnish".¹ As such these are the most suitable money materials and out of them gold is better than silver.

(4) *Portability*—Money is said to be portable if it can be carried conveniently from one place to another. We have already seen that an important function of money is to act as a medium of exchange, i.e., with the help of money people make their purchases and sales. In order to purchase goods one has to carry his money to the market where he wants to make his purchase. This is necessary unless the purchase is

1. Elements of Economics by S. E. Thomas, page 391.

to be made on credit. In case the money material is light and small in size as compared to its value i.e., it is portable, a person can carry his money quite conveniently and without much risk. Similarly a seller, who receives money in exchange of his goods, has to carry it to his residence or bank. In case the money is portable people have less risk and trouble in carrying it and exchange of goods is facilitated. For this reason the money material selected should be such which carries with it great value in small bulk and weight. Consequently gold and silver are better forms of money materials than nickel or brass.

From this point of view diamond, platinum, radium, etc., will be better money materials than even gold and silver; but they have other defects for which they cannot conveniently be used for making money. In some of the rich and commercially and industrially advanced countries of the world even silver was regarded as a money material which was not sufficiently portable and as such it was discarded and displaced by gold. For example United Kingdom, France, U. S. A., etc., used gold for making their high value coins and silver and other metals only for making coins of small value. In the above three advanced countries the average income of the people and the average value of transactions are comparatively very high. Consequently silver currency is not regarded as sufficiently portable. As a country progresses industrially and commercially and the average value of transactions and the average of people's income rise, it requires very portable forms of money. People of such a country favour even the use of paper currency rather than gold or silver. In advanced countries like United Kingdom, France, Germany, U. S. A., etc., there is now little use of metallic money. Several countries of Asia and South America use silver for their money, while most of the countries of the West and North America use gold and paper currency. In India also the difficulties of using silver currency have begun to be felt and for this reason in cities notes are more popular than silver rupees.

(5) *Divisibility and Homogeneity*—The money material should also be such which can conveniently be divided into

parts, and when divided the value of all the parts together should be equal to the value of the whole. This means that the money material should be such which does not lose its value on being divided or broken into parts. Gold and silver can conveniently be divided even into very small parts, and on being so divided they do not lose anything in their value. Diamond on the other hand is defective in this respect. If a diamond is divided into parts it loses value. The total value of all parts of a diamond put together is generally less than the value of the diamond as a whole. Thus diamond is not so divisible as gold or silver.

It is not only necessary that the money material should be divisible, but also that equal parts of the same money material should be of equal value. Diamonds and other precious stones are defective in this respect also. Different pieces of these stones inspite of equal size and weight are not always of equal value, because the value of precious stones also depends upon their lustre and form (vertical or horizontal layer). Homogeneity requires that different pieces of a money material of the same size and weight should be of equal value so that people may be able to assess their value according to these rough standards only rather than work as an expert whose business is to assess the real value by giving the material a complete test. In case the money material is not homogeneous people have difficulty in accepting money made of it freely i.e., without an expert testing, and as every person is not expert in testing, there is difficulty in the exchange of goods and trade and commerce are discouraged. Thus we see that if the money of a country is not made of homogeneous material it is not able to perform its most important function of working as a good medium of exchange.

(6) *Aggregability*—For the money material it is not only necessary that it should be divisible and homogeneous, but it should also be aggregatable i.e., small parts of money material should be capable of being put together into a single mass without losing their value. In order to perform

its function of acting as a medium of exchange and store of value well, it is necessary that money should have this quality as well, otherwise it does not work efficiently and causes inconvenience to the users or stockists. Diamonds and such other commodities are defective in this sense. Different small parts of a diamond can not be combined into a single mass, and as such diamonds can not make a good money material. Thus money material should be both divisible and aggregatable.

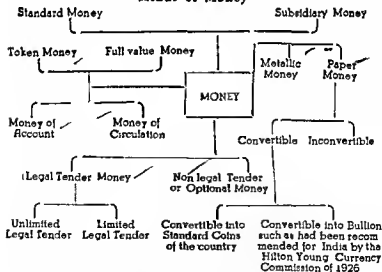
(7) *Cognisability*—Money material should be easily recognisable i.e., people should have no difficulty in recognising or assessing its value. For this reason it is necessary that the quality of the material selected for making money should be simple, and that different coins should be of standard weight, size and style. They should also bear reliable stamp certifying all these facts. In the absence of these people have difficulty in accepting money from others without testing its weight and purity. As it is not convenient to test the quality of metal of a coin and weigh it in every transaction, it does not pass freely from hand to hand. Thus it does not act as a good medium of exchange. For these reasons the issue of metallic money is a function of the state in almost all the countries of the world. The state tries to issue coins of a standard metal, weight, size and style; and these facts are certified by it by putting down its stamp and measure of value on the coins. In old days when coinage was not so efficiently organised, people were compelled to weigh coins and test the quality of their metal before accepting them from others. Thus the transfer of money was not free. People had to carry with them a balance for weighing it and an apparatus for ascertaining the purity of its metal. Such a money can not act as a good medium of exchange, and therefore it is necessary that money material should be easily recognisable.

(8). *Malleability*—The money material should also be malleable. If it is not so or is very hard, it is difficult to print any stamp over it or divide it easily into smaller coins of lower

value. But it does not mean that the money metal should be very soft such as wax or zinc. What is required is that it should neither be very soft nor very hard. If it is very hard it is not easily divisible or aggregatable and it is not possible to put any stamp over it conveniently. On the other hand if it is very soft there is a great wastage in its use due to loss of weight in rubbing. Consequently a great amount of loss is every year caused to the state which issues it and ultimately it has to be borne by the people.

Thus we have seen that whatever commodity be selected by a society to act as money material, it is necessary that it should have a reasonable proportion of all the above qualities if it is desired that its money should perform all its functions properly, cheaply and efficiently. In view of all these facts people have found that gold and silver are most suitable commodities for making money, and as such these metals are used as money in almost all the civilised countries of the world.

Kinds of Money



The above table shows that from different points of view money can be divided into different kinds. Some forms of money are called *Legal Tender Money*, while the others are called *Non-legal Tender or Optional Money*. Legal tender

and facilitate trade and commerce it is necessary that one or two forms of money of the country should be unlimited legal tender or which one is entitled to give or bound to receive in payments in unlimited quantities. In India notes rupees and half rupees are unlimited legal tender money while four annas two annas one anna and half anna pieces and pice are legal tender upto rupee one and half pice and pies are legal tender upto one anna only.

The money of a country can be divided also into *Standard Money* and *Subsidiary Money*. Standard Money of a country is that coin or unit of money in whose terms the values of all other commodities and services of that country are measured, and which is generally also unlimited legal tender such as Rupee in India and Pound Sterling in England. The position of Indian Standard Money i.e. the Rupee is a bit peculiar. For internal purposes India's standard is Rupee and its value is permanently fixed at annas sixteen. For external purposes the value of the Indian Rupee or India's standard money has been artificially fixed in terms of Pound Sterling and since 1927 it is 1s 6d. Previously the Government of India used to maintain that value with the help of the Gold Exchange Standard Reserve Fund. Since the establishment of the Reserve Bank of India this responsibility has been shared by that bank. According to Section 40 and 41 of the Reserve Bank Act 1934 it is the responsibility of the Reserve Bank to maintain the external value of the Indian Standard at a stable rate approximating to 1s 6d.

The history of metallic currency of most of the advanced countries of the world shows that generally the face value of the standard money of a country is equal to its intrinsic value. Before England went off gold standard the intrinsic value of a gold sterling pound was equal to its face or exchange value and England had a free coinage system. On the other hand the intrinsic value of the Indian Rupee is smaller than its face value and since 1893 there is no free coinage in India. Consequently it is incorrect to say that Indian Rupee is the standard coin. It may be called the

From another point of view money of a country can be divided into *Metallic Money* and *Paper Money* or notes. In India metallic money consists of rupees, half-rupees and four anna pieces made of silver, four anna pieces, two anna pieces, one anna piece and half anna pieces made of nickel and pice, half pice and pie made of copper or bronze. On the other hand paper money consists of notes issued by the Government and notes issued by the Reserve Bank of India. The various denominations of these notes are Re 1, Rs 2, Rs 5, Rs 10, Rs 20, Rs 50, Rs 100, Rs 500, Rs 1000, Rs 5000, Rs 10000 etc. Except one Rupee Government of India notes which are to be treated as silver rupees, all other notes are payable to bearer on demand at any office of issue. At present as a War Emergency Measure convertibility of all notes has temporarily been suspended since June 25, 1940. In England currency notes are issued by the Bank of England since 1694 and they are legal tender.

Paper money itself can be divided into two kinds: i.e. *Convertible* and *Inconvertible Paper Money*. If the currency notes of a country whether issued by the Central Bank or the Government are ordinarily at the will of the holder fully convertible into standard money of the country or something else for giving which the currency authority issuing those notes has undertaken a statutory obligation, the notes are said to be fully convertible e.g. all currency notes issued by the Indian Government Currency Department upto 31st March, 1935 and by the Reserve Bank of India after that date. On the other hand inconvertible paper currency whether issued by the Government or Central Bank of any country is that whose holders are not ordinarily able to get in exchange of that from the currency authority of the country standard money or something else promised by the currency authority either statutorily or in practice. For example the paper currency issued by the Central Bank of Germany during and after the old Great War was inconvertible until reorganised in December 1923. At present even Indian Paper Currency is not convertible. Legally Government of India one-rupee notes issued from July 24, 1940 are to be treated as silver rupees while the conversion

of all notes issued by the Reserve Bank of India has temporarily been suspended since June 25, 1940. Further it should be noted that paper currency of a country may be convertible into standard money of the country e.g., the pre-War Indian Paper Currency¹, or it may be convertible into bullion at a fixed rate e.g., the system that had been recommended for India by the Hilton Young Currency Commission of 1926.²

From another point of view the different units of money of a country can be divided into two kinds :—

(a) *Moneys of Account,*

(b) *Moneys of Circulation.*

Those units of money of a country in whose terms the different quantities or amounts of money in that country are expressed and in whose terms the accounts are maintained are said to be the *Moneys of Account* of that country. In India accounts are maintained in Rs. as. and p. and all amounts or quantities of money are expressed in terms of these units of money. Hence they are the moneys of account in India. In England all accounts are maintained in terms of £. s. and d., and all quantities or amounts of money are expressed in terms of these units of money. Hence they are the moneys of account in England. On the other hand *Moneys of Circulation* are those units of money of a country which actually circulate in the market, and which are used as a medium of exchange of goods and services of that country. Sometimes this circulating money contains such units of money which are never used in expressing an amount of money such as half-anna, pice, half-pice, etc., in India and crown, florin, groat, etc., in England.

Coinage

Importance.

Coinage is the name given to the manufacture or making of metallic money. Coins are stamped and certified pieces of metal bearing certain values for which they ex-

1. Section 39 (1) of the Reserve Bank of India Act, 1934.

2. Pages 29 and 55 of the Hilton Young Currency Commission Report.

change for all other commodities and services in a country. In ancient times there were no coins and various commodities in every country exchanged directly for each other. This was commonly known as the barter system. The various difficulties of this system of exchange led to the use of certain common mediums of exchange usually rough ingots of silver and gold of varying weights and quality. The inconvenience of weighing and assaying each time an exchange was effected and a rough silver or gold piece was offered in payment, eventually led to the adoption of shaped pieces of the above metals upon which the weight and fineness had already been certified by a mark or stamp. Thus the object of a suitable system of coinage was to secure uniformity in shape, size, weight and fineness of metal in coins of the same value in order to prevent fraudulent counterfeiting.

Coins or certified pieces of money possess a great advantage that their value can quickly and conveniently be ascertained by merely counting them. Thus the difficulty of weighing and assaying coins each time an exchange is effected has now been removed by a proper system of coinage and thereby trade or exchange of commodities has been greatly facilitated. In the beginning in almost all the countries coins used to be made by gold smiths or indigenous bankers, but this private coinage had the difficulty of lack of uniformity of weight, size, and fineness of metal of coins of the same value. Moreover in course of time there developed also a notion of prestige of sovereignty attached to coins and coinage. Owing to these reasons in almost all the advanced countries coinage is now a function exercised by the government of the country in which every one has confidence. In old days in almost all the countries monarchy was the usual form of government, and coinage used to be regarded as a very important privilege of the king which rarely any of them did not exercise. Present is the age of democracy and almost all the leading countries of the world have democratic forms of government. Consequently in many countries of the world as paper currency is now issued by the central bank of the country, coins may also be made

and issued by the same institution. But the old tradition of government coinage is persisting even now, and in no important country of the world as yet coinage has been handed over to the central bank or any other private agency. At present coinage or the minting of metallic money is a rigidly protected monopoly of the state in most of the countries of the world, and coining is being done in state mints subject to specific statutory laws of the country. In future it is possible that in some countries this may also become a function of the central banks.

Coinage Systems.

With regard to the making of standard coins there are two systems found in the world. In some countries such as U. S. A., United Kingdom, France, Japan, etc., there has been in the past a free coinage system. In others there was a restricted or limited coinage system. Before 25th June 1893 India also had a free coinage system, but since that date India has a restricted one. A country is said to have a free coinage system when any private citizen can bring any amount of bullion he wishes to the mint and get it converted into coins of equal weight without any restriction. Conversion of bullion into coins means a little manufacturing cost. If in any country this little manufacturing cost commonly known as mintage or brassage is charged from the person who wants to get his bullion converted into coins, the system of coinage is said to be free but not gratuitous. On the other hand if in any country even mintage or brassage is not charged from the private citizen for converting his bullion into coins, and the state bears this expense itself the system is said to be a gratuitous and free one. In old days in most of the countries, in spite of free coinage, mintage or brassage was usually charged from the general public on the making of coins.

Modern arrangements differ from those ruling in the past times. Now in most of the countries the State considers it as its duty to manufacture coins for the public free of cost, and the expense of making them is met out of the general budget of the country. Before the old German War, English coinage system was both free and gratuitous. The mint price of gold

in that country was the price at which the metal was coined into the standard currency. The mint used to accept gold for coinage at the rate of £3—17s—10¹/₂d per ounce standard eleven twelfths fine. In other words approximately 3 894 sovereigns were coined out of one ounce of gold. As the coinage was gratuitous, the whole of the bullion received from any private citizen for coinage used to be returned to him in the form of sovereigns. The gross weight of a sovereign was 123 27447 grains and it was eleven twelfths fine. Thus in those days for every 113 0016 grains pure gold received by the mint it used to give one sovereign which contained 123 27447 grains of standard gold and thus no charge was made for this conversion of gold into sovereigns.

In some countries coinage is not free. People have no right to take bullion to the mint and get it converted into coins of equal weight without any charge. In such a country the State does not only charge the actual cost of coinage or brassage, but in addition to that it makes a profit on coinage usually called seigniorage or seigneurage. This may be charged in two ways —

(a) a certain proportion of alloy may be inserted in the coins instead of the precious metal and no allowance be made for this to the person who submits the specie for coinage,

(b) the coins returned to the person who had submitted specie for coinage may contain full weight of the precious metal left, but a direct charge for minting or making the coins may be exacted from him in the form of money payment. Thus in a country where the state charges a seigniorage on coinage there is a difference between the market and the mint price of specie of the standard money. The price at which the mint purchases specie is lower than its market price, or the price at which the mint gives its coins is higher than the cost of making them. In other words in such a country the value of gold or silver as coins is higher than as bullion. There is an appreciable difference between the intrinsic and exchange values of the coins and the country is said to have a restricted or limited gold or silver standard.

Restricted coinage or charging of seigniorage by the currency authorities is advocated by some on the grounds, that coining of metal by the state is a great convenience to the general public. Metal as coins is worth more than as bullion. Coins render a great service to the general public by providing them with a suitable common medium of exchange of their commodities and services. It is such a utilitarian service rendered by the State, that it is quite justified in charging a small fee for it in the form of seigniorage, which also adds to the State revenue of the country. Moreover seigniorage charge also acts as a deterrent against the melting down of coins for use as bullion or for export to other countries. But it must be remembered here that if the seigniorage charge in any country is very high, it may check the demand of metallic currency and affect its power of purchasing or the general price level. If seigniorage or the metal retained is also coined and put into circulation it will increase the quantity of money in circulation and thereby affect its power of purchasing, which will be reduced or the general price level will be raised. On the other hand if seigniorage charge or State profit on coinage is not very high, and the quantity of money in circulation is kept strictly according to its legitimate demand, it may be possible to maintain the value of money in excess of its value as a commodity, provided the public confidence in the solvency and good faith of the currency authority is not shaken.

The issue of metallic currency subject to a very high seigniorage is in principle very much like the issue of inconvertible paper currency. The currency authority has a great temptation to manufacture more and more coins and thereby make larger and larger profits. Consequently under such a system there are great chances of inflation or an issue of metallic currency not justified by the economic condition of the country, with the result that the value of money falls heavily and the general price level in the country is raised, imports from foreign countries are encouraged, exports are discouraged, and all productive industries of the country suffer. Another important objection against restricted coinage and a

of goods purchased. On the other hand shortage or deflation of currency brings about such a fall of commodity prices in the country, that bullion is imported into the country from others in payment of goods exported, and thus the volume of currency is increased. Thus under free coinage the currency system of a country works automatically. There are no chances of unnecessary inflation or deflation—arbitrary currency manipulations, which always do more harm than good to the general economic interests of the country concerned. On account of these reasons free coinage system is regarded as the best and before the old German War most of the important countries of the world such as United Kingdom, U. S. A., France, Germany, etc., had a free coinage system. At present coinage and currency systems of almost all the important countries of the world have gone out of gear, and it will take time to bring back the old conditions.

General Considerations on Coinage.

After deciding the system of coinage whether free or restricted, preferably the former, the currency authorities of a country should proceed to select different metals for making different coins—standard and subsidiary ones. The attributes of a good money material have already been discussed before. Here it is proposed to study only a few important characteristics of good coins.

Firstly the size and weight of coins should be such that the people may be able to handle them conveniently. Neither they should be too big nor too small. As compared to value if the coins are very big, there is difficulty in storing and carrying them from one place to another. On the other hand if they are too small, there are great chances of losing them, for often they slip away from the hands of the users without being noticed. Moreover as compared to value if surface area of the coin is very big, there is great depreciation of the coin due to rubbing in use. Consequently coins of higher values should generally be made of costlier metals and of lower values of cheaper metals. In India the old two-anna silver piece was too small a coin to be handled conveniently. This

is why its coinage was stopped by the Amendment Act of 1913, and it has been replaced by the nickle two anna piece which is very popular

Secondly the shape of the coins should be such that it may not be possible for the people with fraudulent intentions to extract some of the valuable material from them by clipping, sweating, or abrasion without their being detected by other innocent users.

Thirdly the value of each coin should be clearly inscribed on it in all the common languages of the country. As far as possible this value should be shown in terms of its relation with the standard coin of the country. In India though Hindi and Urdu are common languages of the country, yet values of many coins both standard and subsidiary ones are not indicated on them in these languages. This is a defect of Indian coins and should be removed as soon as possible.

Fourthly the coins should be sufficiently hard to prevent a great loss of weight due to rubbing. Generally costlier coins are made of gold or silver. They are very ductile and depreciable metals. To prevent the loss of quick depreciation of gold and silver coins suitable alloys should also be inserted in them and the percentage of the inferior metal so inserted should be declared for the information and guidance of the general public. Use of alloys makes these metals sufficiently hard to prevent their great rubbing and loss of weight.

Lastly the currency authorities should have definite rules with regard to withdrawal from circulation of depreciated and debased coins and their replacement by newer ones. Debased and depreciated coins should not be allowed to remain in circulation for a long time or in large numbers, otherwise there is the danger of loss of confidence of the general public with the result that all good coins may be driven away from circulation, and in their place may remain only bad coins and trade and commerce may suffer.

Coinage in India.

When the British came to India the country was divided into a number of small kingdoms and different coins of gold,

silver and copper were in use in the different dominions. There was no uniform system of coinage for the whole country. The exchange values of the coins were determined by their weight, fineness and the market values of the metals of which they were made. Consequently the values of different coins constantly changed from day to day and nobody could be sure of the exact exchange value of the coins he held. This was very embarrassing to the people. The East India Company also felt great difficulty in carrying on her trade operations and collecting revenue in her territorial possessions which were constantly extending. Thus the Company tried to manufacture gold and silver coins of her own and put them in circulation in her territories at a fixed legal ratio, but as the relation of the market values of gold and silver changed from day to day, the Company's attempt to maintain both silver and gold coins legal tender at a fixed ratio failed, and in actual circulation coins were accepted for their bullion value at the market rate.

For the above reasons it became indispensable that there should be a uniform coinage system. Such a uniformity was introduced by the Indian Coinage Act 1835, which provided that the silver rupee of the weight of 180 grains Troy (165 grains pure metal and 15 grains alloy or 11/12th fine) was to be the standard coin and legal tender throughout British India, and that its coinage was to be free for the public. Even today rupee is the standard money and legal tender. Its weight is the same, but percentage of fineness of metal has been reduced to half. Though legally the Act of 1835 made silver rupee as the only standard coin, yet in practice both gold and silver coins were in use and the authorities encouraged the use of gold mohurs (15 rupee pieces which were of the same weight and fineness as the rupees) by coining and issuing them to the public at the ratio of 15 silver rupees to one gold mohur. This state of affairs continued upto 26th June 1893, when Act VIII of that year closed the Indian mints to the unrestricted coinage of silver rupees for the public, and no Government rupees were coined

till February 1900 when it was again considered necessary and hence taken up.

The Indian Coinage Act III of 1906 consolidated and amended the law relating to coinage in India. This Act provided for the minting of three kinds of coins namely silver, nickel and bronze. With regard to silver coins the Act provided for the minting of a rupee, a half-rupee, quarter-rupee, and a two anna piece with the following standard weights and fineness of metal:—

Name of the coin	Gross weight in grains Troy	Percentage of fineness	Quantity of pure silver in grains Troy.	Quantity of alloy in grains Troy
Rupee ...	180	11/12th	165	15
Half-rupee...	90	11/12th	82'5	7'5
Quarter rupee ...	45	11/12th	41'25	3'75
Eighth of a rupee ...	22'5	11/12th	20'625	1'875

Rupee, Half-rupee and Quarter rupee are minted even today and have the same weights as were originally fixed by the Coinage Act of 1906, but their fineness of metal has been reduced to half of their gross weights. The minting of silver Two-anna Piece has been suspended by the Indian Coinage Amendment Act 1918.

With regard to nickel coins the Act of 1906 provided for the minting of only One-anna Piece. The Amendment Acts of 1918 and 1919 made further provision for the coining of nickel Eight-anna, Four-anna, and Two anna pieces with 120, 105, and 90 grains Troy respectively as their standard weights. The standard weight of One-anna Piece is 60 grains Troy. The minting of nickel Eight-anna Piece was suspended by the Coinage Act of 1920 and all such coins were gradually withdrawn from circulation. On account of wartime activities the demand for small coins has greatly increased in recent years, and issues of pice pieces in particular have more than doubled. The Government of India therefore issued in January 1942 a new half-anna coin in nickel-brass alloy of 45 grains.

With a view to economise the use of nickel the one-anna coin and later the two-anna coin have been replaced by a nickel-brass alloy instead of the old cupro-nickel alloy.

Originally copper coinage was introduced into Bengal by Act XVII of 1835 and in Madras and Bombay presidencies by Act XXII of 1844. Copper coinage was replaced by bronze coinage by the Coinage Act III of 1903. This Act provided for the minting of bronze Pice or Quarter-anna, Half-pice or one-eighth of an anna, and Pie being one-third of a pice or one-twelfth of an anna. The standard weight of the pice was fixed at 75 grains Troy and the other bronze coins were to have proportionate weights. The minting of these coins today is the same as was originally provided in the Act of 1906 except pice whose weight has been reduced to 40 grains Troy from 1943.

Table Showing Present Coins of India, their Gross Weights and Fineness.

Denomination.	Gross Weight.	Fineness.
Silver—		
Quaternary Rupee	180 grains Troy.	50 per cent.
“ Half-Rupee	90 grains Troy.	50 per cent.
“ Quarter-Rupee	45 grains Troy.	50 per cent.
Nickel—		
2 Anna piece	90 grains Troy.	} 79 per cent. brass, 20 per cent. zinc, and 1 per cent. nickel.
1 Anna piece	60 grains Troy.	
Half-anna piece	45 grains Troy.	
Copper—		
Pice	40 grains Troy.	} Brass and zinc.
Half-pice	37.5 grains Troy	
Pie piece	25 grains Troy.	

Table Showing Total Mintage of Coins during 1943-44 at the Bombay Calcutta and Lahore Mints

Denomination	Bombay Mint	Calcutta Mint	Lahore Mint	Total
	Rs a	Rs a	Rs a	Rs a
Quaternary Rupees	8 49 00 636 0		98 00 000 0	7 47 00 636 0
Quaternary Half Rupees	4 04 50 000 0		2 02 50 000 0	6 07 00 000 0
Quaternary Quarter Rupees	3 45 00 000 4	1,74 10 892 12	59 25 000 0	5 78 35 893 0
Nickel 2 annas	3 50 72 500 0			3 50 72 500 0
Nickel 1 anna	74 62 000 0	2 50 30 000 0		3 24 92 000 0
Nickel half anna		1 44 78 000 0		1 44 78 000 0
Single pie	32 64 800 0		1 64 187 8	34 28 987 8
Total	18 56 49 936 4	5 69 18 892 12	3 61 39 187 8	27 87 08 016 8

Table Showing Absorption of Coins in India in Lakhs of Rupees.

Denomination.		1938-39.	1939-40.	1940-41.	1941-42.	1942-43.	1943-44.
<i>Silver</i> —							
Rupee Coins and Government of India One Rupee Notes from July 1940.		-12,60	+10,08	+33,23	+7,18	+44,93	+23,14
8 Annas ...	...	+2	+60	+1,53	+1,57	+3,82	+5,41
4 Annas ...	...	-5	+31	+1,02	+1,29	+2,97	+5,19
Total Silver Coins including Government of India One Rupee Notes from July 1940.		-12,63	+10,99	+35,78	+10,04	+51,72	+23,74
<i>Nickel</i> —							
4 Annas ...	...	-4	+8	...	-2	-10	-2
2 Annas ...	...	+4	+48	+72	+88	+2,22	+3,34
1 Anna ...	...	+6	+51	+76	+99	+2,02	+3,11
Double Pice or Nickel Half-anna	...	...	...	...	+4	+57	+1,14
Total Nickel Coins ..	...	+6	+1,07	+1,48	+1,89	+4,71	+7,57
<i>Copper</i> —							
Pice ...	...	+14	+21	+23	+29	+13	+29
Half-pice ...	...	+1	+1	+1	+1	...	...
Pie Pieces ...	...	+1	+1	+1	+1	+1	...
Total Copper Coins	...	+16	+23	+25	+31	+14	+29
Total Small Coins	...	+19	+2,21	+4,28	5,06	+11,64	+18,46

+ Indicates Absorption.

- Indicates Return.

Diminished Defaced and Counterfeit Coins

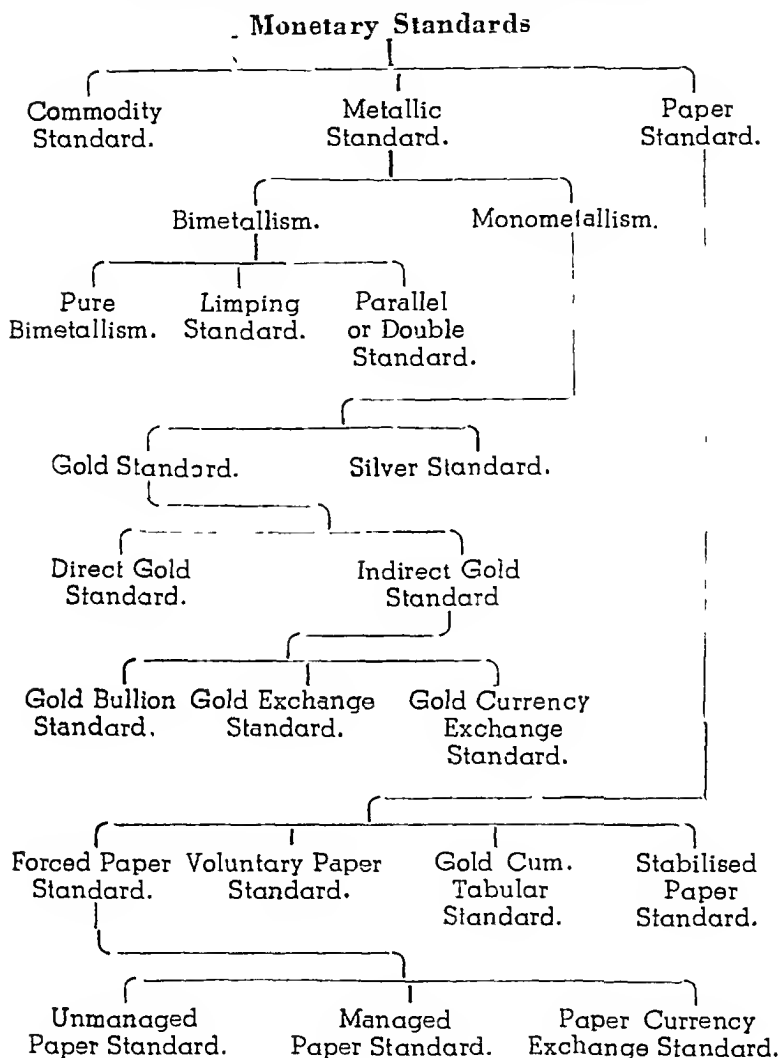
Coins that are counterfeit fraudulently defaced or diminished in weight more than the prescribed percentage of reasonable wear are not legal tender. They cannot be forced on others in payment. If any such silver coin is tendered to any person authorised by the Governor General in Council or by the Local Government and that person has reason to believe that the coin is counterfeit, defaced or has lost in weight so as to be more than two per cent below the standard weight, he has a legal right to cut or break the coin and return the pieces to the person tendering the coin, who shall bear the loss caused by such cutting or breaking or receive and pay for the coin according to the value of the silver bullion contained in it. In case of nickel coins also the above persons are entitled to cut or break them if they have reason to believe that any such coin tendered to them is counterfeit.

Questions

- 1 What should be the chief characteristics of a good money material? Explain.
- 2, Why is it that gold has been considered as the best money material? Explain.
- 3 Classify the various forms of money used in India and explain the main characteristics of each.
- 4 Can token money be unlimited legal tender? What constitute unlimited legal tender in India?
- 5 Explain —
 - (a) Standard Money
 - (b) Money of Account
 - (c) Paper Money
 - (d) Optional Money
 - (e) Currency
- 6 What is coinage? What is the importance of a proper system of coinage for a modern country?
- ✓ 7 Name the different systems of coinage and explain them.
- 8 Describe briefly the history of coinage in India from 1800 to 1940.
- 9 Write short notes on the following —
 - (a) Seigniorage (b) Counterfeit Coin and (c) Remedy Allowance
- 10 Give your arguments for and against a system of free and gratuitous coinage.

CHAPTER III

PROBLEM OF MONETARY STANDARD



Commodity, Metallic and Paper Standards

In the previous pages we have studied that barter system of exchange is full of inconveniences. Consequently people of every country require money or currency to help them to

carry on their various economic activities cheaply and efficiently. The currency or monetary system of every country consists of various money units i.e. the standard money and the subsidiary money. Out of all money units of a country the standard money is the most important for the reason that all other money units are but only representatives of the standard money. The values of different units of subsidiary money of a country bear fixed relations with the standard money and they form either the fraction or the multiple of the value of the standard money. For this reason the money or currency system of a country is generally named after the commodity of which its standard money is made or the principle on which its exchange value is based by the currency authority of the country. Broadly speaking there can be only three kinds of currency systems viz. Commodity Standard Currency System e.g. wheat standard skin standard ox standard etc. (2) Metallic Standard Currency System e.g. gold standard silver standard etc. and (3) Paper Standard Currency System e.g. forced or voluntary paper standards such as German paper mark standard during and after the old Great War until reorganised in December 1923 the Bank of England Note Standard after September 21 1931 or the Stabilised Dollar Standard advocated by Prof. Fisher.

Commodity Standard—In this money or currency system the standard money consists of a commodity e.g. wheat, tea, ox, skin, tobacco, goat etc. The values of all other commodities and services of the country which has this standard are expressed in terms of that commodity which is selected to act as the standard money. This standard money also helps in the exchange of commodities and services of the country as far as it is possible for it to do so. Such standard monies and currency systems existed in some of the countries of the world long ago. But it must be noted that these forms of standard money suffered from numerous defects e.g. destructibility, indivisibility, instability of value, unportability etc. On account of these defects in course of time they were displaced by metallic currency system in almost all the

countries of the world, and at present there is no civilised country which has a commodity currency standard.

Metallic Standards

Monometallism—In this currency system the standard money is either made of some metal or is freely convertible into it. Generally the metal is gold or silver. Standard money may be made of gold or silver or it may be convertible into either of these. If the standard money of a country is made of only one metal either gold or silver, or is convertible into only one of these metals, the system of currency is said to be a monometallic currency system. For example at present in almost all the countries of the world the standard money is made of either gold or silver, or is convertible into one of these metals only (generally the former) and they are said to have monometallism. If the standard money of a country is made of only gold or is convertible into gold only at a fixed rate, it is said to be a gold standard currency system. On the other hand if the standard money of a country is made of only silver or is convertible into silver only at a fixed rate, it is said to be a silver standard currency system.

Gold standard itself is of various kinds. ¹ If the standard money of a country is made of gold and its coinage is free or mints are open to the public for its coinage, the country is said to have a direct gold standard or gold currency standard. (On the other hand if the exchange value of the standard money whether of gold, silver or paper is fixed in terms of gold at a fixed rate, it is said to be ² an indirect gold standard. Convertibility of standard money into gold may take various forms. Firstly the standard money may be freely convertible into gold bullion at a fixed rate both for internal consumption and foreign payments. This is said to be ^{2a} gold bullion standard. Secondly standard money of a country may be convertible into gold bullion at a fixed rate only for purposes of enabling people to make foreign payments. This is said to be gold exchange standard. Thirdly the standard money of a country may be convertible at a fixed rate into the currency of another country

which may have a direct gold standard. This is said to be gold currency exchange standard

Bimetallism—If in any country standard coins are freely made of both gold and silver at a fixed ratio, or its standard money is freely convertible into both of these metals at fixed ratios, the system of currency is said to be a pure bimetallic currency system. Bimetallism worked in European countries for many centuries. Before 1878 all countries of the Latin Monetary Union had bimetallism U. S. A. adopted it in 1792, when silver dollars containing 371 1/4 grains of fine silver, nine-tenth fine were freely minted and exchanged against gold dollars also freely made containing 24.75 grains of fine gold out of 27 grains of total weight or standard gold

If in any country the standard coins be made of both gold and silver, but the coinage of gold be free while that of silver be restricted in order to maintain between gold and silver coins a ratio that is assigned to them at the mint, the system of currency is said to be a 'limping standard' Such a system of currency existed in France and Belgium from 1873 and in countries of the Latin Monetary Union from 1874 till it was finally replaced in them by a monometallic gold standard by the close of the 19th century. From 1873 the price of silver began to fall and in all bimetallic countries the mint ratio between gold and silver coins being fixed at the old values, gold coins in circulation began to be threatened of replacement by silver. Countries not willing to lose their more valuable gold for cheaper silver stopped the free coinage of silver. This was first done in 1873 by France, which was a bimetallic country till then. Later on Belgium and countries of the Latin Monetary Union also replaced bimetallism by a limping standard.

If in any country the standard coins be made of both gold and silver, but not at any fixed ratio between them and the coinage of both be free or open to the public, then the system of currency is said to be a 'double or parallel standard.' In this system unlike pure bimetallism, the mint does not fix any ratio at which coin of one metal is to exchange against that of the other. Both in circulation and at the mint coins of the

two metals exchange against each other according to their market fluctuating ratio from day to day. Such a system was introduced in England in 1663 ; but soon after was given up for it compelled traders to maintain two sets of prices of their commodities *viz.*, the gold standard prices and the silver standard prices, because the two standards themselves continually stood in a fluctuating ratio to each other.

Paper Standard—In the previous pages it has been seen that the standard money of a country may consist of a commodity or metal like gold or silver or both. It may be noted here that a country's currency standard may also be of paper *i.e.*, a paper note issued by the Government or Central Bank of the country. A country may be compelled to have a forced paper standard due to inconvertibility of its notes into gold or silver owing to shortage of metallic reserves *e.g.*, *German paper-marks before stabilisation in December 1923*, or *Bank of England notes after September 21, 1931*. A forced or compulsory paper standard can again be subdivided into two kinds *i.e.*, *Unmanaged Paper Standard* and *Managed Paper Standard*. *German paper-mark before December 1923* and *Bank of England notes from September 1931 to July 1932* were unmanaged paper standards, but after July 1932 Bank of England notes are a managed paper standard. In addition to these there may be one more form of compulsory paper standard *e.g.*, *the Indian Paper Currency Exchange Standard from September 1931*. On the other hand a country may adopt a paper standard voluntarily in order to correct the foreign exchange values of its standard to suit the country's economic conditions such as U. S. A. did in 1933 and France in 1936. Besides this a country may adopt a paper standard voluntarily with a view to realise a superior currency ideal such as Prof. J. M. Keynes *Gold Cum Tabular Standard* advocated to insure equity in deferred payments between debtors and creditors or Prof. Irving Fisher's *Stabilised Paper Dollar Standard* advocated with a view to provide a currency with a stable purchasing power.

It should be noted here that in cases of all the above paper

standards, "it is not the paper of which the note or the standard money is made which commands an exchange value or power of purchasing other commodities and services of the country, but it is the authority of the Central Bank or the Government that the note bears on its face that makes it the country's currency standard. The note is altogether a different entity from the paper and has some value in the market, which the paper as such has not. Not even during the worst days of depreciation at the German paper mark, was the mark note no more in value than the paper it was printed upon."¹ Thus though usually these currency standards are called paper standards yet accurately speaking they are not real paper standards and should not be called as such. Really these are indirect or remote metallic standards for they represent some, though indefinite and uncertain quantity of gold or silver obtainable against them.

Bimetallism

[It is a system of currency in which standard coins of two metals circulate freely side by side. Generally they are made of gold and silver and both of them are legal tender to unlimited extents. Coinage of both the metals is free and unrestricted; i.e., mints are open to the coinage of both the metals freely. The two coins exchange for each other at a fixed fiduciary ratio. This is commonly known as the *multiple legal tender* or more appropriately a *pure bimetallic currency system*. It has a number of defects. In this system so long as the mint ratio or the fiduciary relation between the two coins coincides with the market relation of their intrinsic values there is no difficulty either internally or externally and the system works quite satisfactorily, but as soon as there is a difference between the legal ratio and the market ratio or the ratio of the intrinsic values of the two standard coins the system is thrown out of gear, because conditions are created for the bad money to drive away the good money out of circulation. The moment such a variation occurs one coin becomes an under-

¹ Article on Classification of Currency Standards in Indian Journal of Economics of October 1936 by Prof B. R. Shenoy, page 133.

valued or good money and the other an over-valued or bad money, and then the bad money tries to drive away the good money out of circulation. The good money may be driven to hoards, be melted and consumed for social purposes, or be exported to foreign countries as bullion in payment of debts; for in all these latter uses it gives to the holder a higher exchange value than when used inside the country as money. Thus the exchange value of good money as bullion becomes higher than as money or legal exchange value.* Hence there are great temptations to use this money for export or non-monetary purposes.) Before 1873 France, Belgium, and the countries of the Latin Monetary Union in Europe had a bi-metallic currency system. After that date the price of silver in world markets began to fall in terms of gold with the result that in these countries the danger of the displacement of costlier gold by cheaper silver became imminent. Consequently in course of time all these countries had to give up bimetallism.

Before 1835 India also had bimetallism and both gold and silver coins issued by the East India Company were in circulation at a fixed legal ratio. This legal or fiduciary ratio could not be maintained by the currency authorities as the relation of the market values of the two metals was constantly fluctuating and it always threatened the smooth working of the currency system. Owing to these great inconveniences bimetallism was ultimately given up in 1835, when under the Currency Act of that year Silver Rupee of 180 grains (165 grains pure metal and 15 grains of alloy or 11/12th fine) was declared to be the standard coin and unlimited legal tender in British India. Further it was enacted that no gold coin shall thenceforward be a legal tender of payment in any of the territories of the East India Company.

(The advocates of bimetallism assert that there can not be any very serious difficulty in the working of this system in any country. They say that even if at any time the relation of the market values of the two metals may become different from their fiduciary relation and as such coins of under-valued metal may disappear from circulation and coins of over-valued

metal may only remain in circulation, shortage of currency owing to the disappearance of coins of under-valued metal from circulation will increase the demand of currency, and as such the value of the over-valued metal will begin to rise and ultimately come back to the older level or fiduciary ratio. They believe in the compensatory¹ effect of the double standard. For example suppose in a country there are coins of both gold and silver in circulation at a fixed fiduciary ratio of 1-to 25, and the same is the relation of their market values. After some time gold becomes dearer in terms of silver and their market ratio becomes 1 to 30. This will mean that gold coins will disappear from circulation and shall be used as bullion. Many gold coins converted into bullion will also be sold in terms of silver. The result of this will be, that there will be a great shortage of currency and the demand of silver coins will increase. These facts will have their compensatory effect on the value of silver. Its demand for monetary purposes will be greatly increased. The result will be that its value will increase and ultimately come back to the older level or fiduciary ratio.

1. Jevons calls it equilibratory action and explains it as follows.—

✓ 'If silver becomes more valuable—compared with gold there arises at once a tendency to import gold into any country possessing the double standard so that it may be coined there and exchanged for a legally equivalent weight of silver coin to be exported again ... If gold rose in value compared with silver the action would be reversed, gold would be absorbed and silver liberated. At any moment the standard of value is doubtless one metal or the other and not both, yet the fact that there is an alternation tends to make each very much less than it would otherwise do. It cannot prevent both metals from falling or rising in value compared with other commodities but it can throw variations of supply and demand over a larger area instead of having each metal to be affected merely by its own accidents.

Imagine two reservoirs of water, each subject to independent variations of supply and demand. In the absence of any connecting pipe the level of water in each will be subject to its own fluctuations only. But if we open a connection, the water in both will assume a certain mean level and the effects of any excessive supply or demand will be distributed over the whole area of both reservoirs. —Money and the Mechanism of Exchange—pp. 130-140

The advocates of bimetallism believe in the compensatory effect of the double standard, but one very important fact which is over-looked in the above arguments is, that it is just possible that all gold coins converted into bullion may not be offered for sale against silver coins. Some of these may be exported or consumed for social purposes, and increased demand of silver may lead to its import from other countries of the world, some of which may become inclined towards gold and may try to unload their cheap silver in the above country. Thus it is just possible that at such a time there may crop up forces, which instead of correcting the discrepancy between the market and legal ratio of the two metals, may even accentuate that discrepancy, and the country thus be forced down to give up bimetallism and adopt a silver standard.

For the successful working of bimetallism under the machinery of compensatory action of the double standard, it is necessary that there should be an international agreement with regard to the export and import of specie. We know that several attempts¹ in the 19th and the present century *i.e.*, the various international monetary conferences resulted in failure. Even if an international agreement be possible, no useful purpose would be served by adoption of a bimetallic arrangement between the nations, for due to the preference of the banking world for gold, its use in payment of international balances would not be affected. Moreover at present when most of the countries of the world have already adopted a gold standard, the real effect of bimetallism would be to introduce an alternative standard, now of one metal and at another time of the other. No ratio established by law would be long maintained and the metal which becomes relatively cheap in the market would become the real standard, the other being used as bullion.²

Lastly it is worth noting that the chief reason of several serious attempts made during the last quarter of the 19th

1. Paris Conference, 1878. Brussels Conference, 1892. Laussane Conference, 1933.

2. Money and Banking by W. A. Scott, page 333.

century to reinstate bimetalism was the fact, that then different countries of the world were on different standards—some on gold standard while others on silver standard. Bimetalism was then an attempt to make the foreign exchange relations of such countries more harmonious by making it possible to establish fixed rates of exchange and allow frequent fluctuations of values of the different standards within a smaller range both internally and externally, rather than a smaller number of changes but of considerable magnitude. But as has already been noted before, at present when most of the countries of the world have adopted a gold standard with or without active circulation of gold coins inside the country bimetalism as a practical proposition of a possible currency system has no force. Consequently at present it is a problem of only theoretical interest.

Limping Standard—In this system of currency standard coins are made of two metals both gold and silver, and both are unlimited legal tender. The coinage of gold is free or unrestricted i.e., for coinage of gold mints are open to the public, but the coinage of silver is restricted or for its coinage mints are not open to the public. This is really a modified form of bimetalism. Under bimetalism when the market ratio of two metals becomes different from the mint ratio, say for example silver becomes cheaper in terms of gold and therefore the intrinsic value of silver standard becomes smaller than its fiduciary value, there is the danger of the replacement of costlier gold coins by cheaper silver coins. In order to check this displacement of gold coins by cheaper silver coins, the increase in the silver standard coins is checked by stopping their free coinage.

When the currency authorities do not make silver coins at old rates, and nobody has an authority to do so, the result is that their exchange value is slowly raised to the older level. When it is achieved exchange value of silver coins comes at par with that of gold coins although their worth as bullion is much less. Internally this system begins to work as gold standard, though for external payments limping standard has

an element of uncertainty for sometimes the currency authorities charge a premium in converting cheaper silver currency into gold bullion. The same result of raising the exchange value of silver currency can also be achieved by imposing either an import duty on silver or an export duty on gold of an amount that may neutralise the difference between the mint and market ratios of gold and silver standards. But it must be noted that in order to get the desired result, as compared to the latter methods, restriction or complete cessation of free silver coinage is more effective for the reason that it is difficult to check the smuggling of gold or silver, which may not escape the customs duties. Even the former method is fraught with dangers of counterfeiting the silver coins so long as market price of silver remains lower than the mint price.

Bimetallic countries of France and Belgium stopped in 1873 the free coinage of silver five-franc pieces which were full legal tender, as the market price of silver fell down. Later on the countries of the Latin Monetary Union, which were also on bimetallism, stopped the free coinage of silver and adopted a limping standard until it was replaced by a gold standard in course of time. In no country limping standard was ever established by design, but it cropped up only through a series of tentative steps to adopt a gold standard. India also adopted a limping standard from 1898. Before 1893 India had a free silver standard, but owing to a heavy fall of the market price of silver in terms of gold in the world markets, India's burden of foreign gold payments became very heavy. Consequently in order to raise the exchange value of the rupee in terms of gold, free coinage of silver was stopped in 1893 according to the recommendation of the Hershell Committee. In 1898 according to the recommendations of the Fowler Committee sovereigns and half-sovereigns were made full legal tender coins in India and their exchange values in terms of rupees were fixed at Rs. 15/- and Rs. 7/8/- respectively. For some time this system worked without any serious difficulty, but the rise in the price of silver during and after the Great War compelled the Government of India to change the legal ratio of the sovereign from Rs. 15 to Rs. 10. Ultimately by the

Currency Ordinance of June 21st, 1920, sovereigns and half-sovereigns ceased to be legal tender in India. Thus we see that limping standard is not a suitable currency system for any country to adopt permanently, but in a change from bimetallism or silver monometallism to a monometallic gold standard it is a necessary intermediary measure.

Parallel Standard—It is also a modified form of bimetallism. In this system of currency as well standard coins are made of both gold and silver. Both the coins are freely minted and are unlimited legal tender. It differs from the pure bimetallism only in this respect, that in this system there is no legally fixed or fiduciary ratio between the gold and silver standards. Both at the mint and in circulation they exchange for each other according to their day to day market ratio of intrinsic values. Such a system was introduced in England in 1663 and existed in India before 1835. This is a double standard in the real sense of the term. In this system at no time there is any danger of any money becoming bad or overvalued or any money becoming good or undervalued, and as such any money driving away the other out of circulation to private hoards or export to foreign countries.

One of the most important functions of money of a country is to act as a common measure or standard of exchange values of all its commodities and services. Parallel or double standard is bad for under it money of a country does not perform this one of its most important functions properly. Under this system every person is required to maintain a double set of prices of his commodities or services i.e., gold prices and silver prices. Moreover as market ratio of the exchange values of these two metals differs from time to time, the prices of various commodities and services also fluctuate constantly. No one can even for a moderate period of time be sure of the real value of the coins he holds. In concluding even small transactions parties are compelled to ascertain first the day's market ratio of the intrinsic values of the two standard coins and then fix the price or amount involved in the transaction. On account of these formidable difficulties the system is regard-

ed as most unsatisfactory and both in England and India it worked but only for a short period. In this country it was soon replaced by a monometallic silver standard under the Currency Act of 1835.

Monometallism

In this system of currency the standard money is made of or is convertible into only one metal gold or silver. If the standard money is made of or is convertible into gold only, the country is said to have a monometallic gold standard such as United Kingdom, U.S.A., Japan, etc. On the other hand if it is made of or is convertible into silver only, it is said to be a monometallic silver standard such as India had from 1835 to 1893, China before November 1935, and at present perhaps Manchukoo. Under monometallism only one metal forms the standard money or the standard of value. Standard money of only one metal is unlimited legal tender and the mints are open to the public for the coinage of standard money of only that one metal.

Upto the beginning of the 19th century some countries of the world had monometallism, but most of the others had bimetalism. During that century many important countries of the world gave up bimetalism and adopted gold monometallism or the gold standard. During that century, specially in its latter half, gold price of silver fell very heavily in the world markets, with the result that the currency authorities of the various bimetallic countries could not maintain the official mint ratio of their gold and silver standard coins, and ultimately gave up bimetalism. England adopted gold monometallism in 1816, Germany in 1873, Russia in 1877, Japan in 1897, and United States of America in 1900. During the time of Moghuls and up to 1835 India also has had a sort of bimetallic currency system, but since that date India also adopted a monometallic currency system but that of silver standard.

Under monometallism as the standard money is made of only one metal, and mints are open to the public only for its coinage, and standard money of only one metal is unlimited legal

lender, there is no danger of any money of the country becoming over-valued or under-valued and no danger of any money being driven away out of circulation. If a country has a monometallic currency system of the same metal, which most of the other countries with which it trades have, there are few possibilities of any great difference between the internal and external exchange values of the money of such a country affecting her trade, commerce and industry adversely. Consequently unless checked by artificial measures like prohibition or imposition of heavy customs duties on the import or export of specie, exchange control, differential fiscal policy, etc.; trade and commerce in and between such countries has great chances of being carried on quite smoothly. Goods and specie would move from one country to another according to their prices or exchange value. The specie or bullion will try to maintain an equal purchasing power between different countries, by moving from countries where it is in excess and commands a lower purchasing power, to countries where it is in great demand and commands a higher purchasing power. Consequently for a policy of free international trade, a monometallic currency system of the same metal is very helpful.

There is no doubt that if a country has a gold monometallism while others with which it mostly trades have a silver monometallic currency system, there will be both very frequent and steep fluctuations in the internal and external exchange values of the money of such a country. There will be great and frequent disparities in prices of goods between such countries and trade and commerce will seriously be hampered. On the other hand if a country has bimetallism and the other countries with which it has trade relations have monometallism whether of gold or silver, there are less possibilities of steep fluctuations in the exchange ratio of standard moneys of such countries. At present when most of the countries of the world have adopted a gold monometallism, bimetallism has only a theoretical interest and is not at all a practical proposition. Monometallism with or without active circulation of metallic standard money is the order of modern times.

Silver Standard—Under this system the standard money is made of silver and there is a free coinage of that metal. People are authorised to bring silver to the mint and the currency authority is always prepared to give freely silver standard coins of full weight in exchange of silver bullion presented. The face value of the standard coin is equal to its intrinsic value, and there is no difference between the mint and market price of silver. Silver is the standard both for internal and external requirements of the country. Internally it exchanges for other coins and paper currency at certain fixed rates, and for other commodities according to its quantity. Externally the standard coin is valued in terms of silver standards of other countries according to the relation of their weights and fineness of metal; while in terms of gold standards of other countries, besides weight and fineness, it is valued according to the relation of the market values of silver and gold. Such a system of silver standard currency was introduced in India in 1833 and somehow or other worked upto 1893, when it was given up.

As the price of silver in terms of gold does not remain stable in the market for even a moderate length of time, the external value of the silver standard of a country in terms of gold standard countries is always a fluctuating one, and depends on the market ratio of the values of the two metals. Thus external purchasing power or foreign exchange rates of a silver standard country in relation to gold standard countries, do not remain stable for even short periods of time. Most of the countries of the world have now adopted a gold standard. Consequently a silver standard country can not now have her foreign exchange rates stable with regard to most of the countries of the world, and her trade, commerce and industry cannot work smoothly and prosperously. Sometime the people of such a country shall have a period of great commercial and industrial prosperity, while at another time they shall suffer from a great depression, for owing to fall and rise of the price of silver in terms of gold, the external prices of the various commodities of this country shall always fluctuate very widely in terms of currencies of other gold standard countries. Thus trade and commerce of such a country shall

always remain uncertain owing to constant instability of the value of her money, and the country as a whole shall suffer

At present when all important countries of the world have adopted a gold standard, when international trade relations between different countries have so much developed, and when prices of different commodities in each country, whether produced internally or imported from abroad, are so greatly affected by foreign exchange fluctuations, it is almost impossible for a country to carry on its various economic activities smoothly by adopting a silver standard. For these reasons now there is hardly any important country which has got a silver standard in the strict sense of the term. Even countries whose standard money is made of silver, have a silver standard only for internal purposes while for external purposes they have adopted a gold standard in some form or the other.

Gold Standard

In the strict sense of the term, gold standard system means one in which the standard money of a country is made of gold. Gold is in actual circulation in the country and is the standard for measuring the exchange values of all commodities and services and a medium of their exchange. Notes issued by the Government or the Central Bank of the country are valued in terms of gold, and are always convertible into legal tender gold coins whether required for internal use or for export. Gold standard coins are unlimited legal tender. Their coinage is free and open to the public i.e. there is no difference between the mint and market prices of gold. Such a gold standard existed before 1914 in the United Kingdom, France, U. S. A., Germany, Japan etc. At present in the original sense of the term gold standard does not exist in any important country of the world.

After the old German War most of the important countries of the world adopted modified forms of gold standard or indirect gold standards, such as gold bullion standard, gold exchange standard, gold currency exchange standard, etc. Consequently the original gold standard is now distinguished from these indirect or modified forms of gold standards by

naming it as direct gold standard or gold currency standard. For these reasons at present gold standard means a currency system in which either the standard money is itself made of gold or is convertible into gold directly or indirectly and either freely or under certain restrictions. Thus the term gold standard now means any of these standards :—gold currency standard, gold bullion standard, gold exchange standard or gold currency exchange standard.

One thing to be noted here is, that whatever be the form of gold standard whether direct or indirect, the advantage possessed by it is that as compared to other standards, it insures greater internal and external stability of the exchange values of the money of the country unless that is checked by artificial barriers such as restriction or embargo on the import or export of gold, exchange control, etc. There is no doubt that during the world economic crisis of 1929-32 most of the important countries of the world had gone off gold standard, but the desirability of an early restoration of an effective gold standard had very well been emphasized by the World Economic Conference held at Locussane in 1933. Even at present when owing to World War the monetary systems of many countries have become upset there are schemes afloat for a proper post-war currency reconstruction. The opinion of currency experts is that future lies not in the dethronement or the abandonment of the gold standard, but in its better management and further development.

Gold Currency Standard—As already mentioned before gold currency standard means a currency system in which the standard money is made of full-bodied gold coins, which are in active circulation in the country and can freely be used for making even foreign payments. Mints are freely open to the public for making gold standard coins and the value of the currency unit varies with that of gold. There is no difference between the mint and market prices of gold and there exists in the country a free market for it. Such a standard and currency system was in existence in United Kingdom, U. S. A., Germany, Japan, etc., before the last

Great War. The greatest advantage of this system is that under it the standard money commands an exchange value equivalent to its intrinsic worth. Unless a country goes off gold standard never there is any appreciable difference between the fiduciary and metallic values of its standard money. The system is natural and free from all sorts of artificial restrictions and possibilities of currency manipulations. The general price-level of the various commodities and services of the country remains always almost stable. The prices of goods do not fluctuate heavily either in terms of the currency of the country or externally in terms of the currencies of other countries of the world, which are also on a gold standard.

The foreign values of money of such a country do not fluctuate very widely, and all heavy fluctuations in them are soon corrected by the import or export of gold into or from the country. Thus unless raised or lowered artificially by means of import or export duties, embargo or restriction on the import and export of gold, exchange control, etc.; the prices of commodities produced in the country as well as of those imported from abroad remain more or less the same; and trade, commerce and industry of the country do not suffer from high fluctuations of the internal or external commodity prices due to the instability of the value of money. Gold flows freely from countries where it has a low purchasing power or exchange value to those where it commands more, and tries to maintain a parity. On account of these reasons the system is very efficient and commands great public confidence. As gold is contained in the money of the country and is always available to the people, it discourages the habit of hoarding the precious metals and encourages the tendency of investment and credit—a point which can not lightly be put off specially with regard to countries like India.

The greatest disadvantage of this system of currency is that it is very expensive. In a gold currency standard country gold is required both for internal circulation as well as for settlement of net balance of foreign transactions. This drawback of the system: *e.*, its costliness can be overcome to a great

extent by a suitable development of paper currency and bank money to replace the use of metallic currency inside the country. A weakness of this system which came to light prominently during the world economic crisis of 1929-32 is that its smooth working among different countries can be dislocated or shattered by some of those countries going off 'gold standard or adopting other means of restricting the movement of specie from one country to the other, such as exchange control, trade restrictions, price manipulations, etc. In that crisis many important countries of the world went off gold standard and devalued their currencies in terms of gold very heavily either voluntarily or involuntarily and forced the world currency and exchange systems to be completely shaken and occupy chaotic conditions. But it must be noted that trouble was not the result of any inherent defect of gold currency system, but that of a deliberate disregard of its right principles. One fact that had helped much in bringing about that breakdown was, that after the last World War almost all important countries of the world had given up gold currency standard and adopted modified forms of gold standard, which could be manipulated more easily. Thus the breakdown of the world currency and exchange systems during the crisis of 1929-32 was really the consequence of those manipulations rather than the outcome of any natural weakness of gold currency standard system.

Gold Bullion Standard—After the last World War many important countries of the world, which were on a direct gold or gold currency standard before, reorganised their currency systems on a model which is now commonly known as Gold Bullion Standard. Under this system most of the currency that circulates inside the country consists of notes and they are convertible into gold at the will of the holder. The value of the currency unit or standard money is stabilised in terms of gold by offering to redeem the currency notes into bullion instead of gold coins. The currency authorities offer to buy and sell gold bullion at certain fixed rates, the difference between the two prices representing the handling charges. Mints are closed to the free coinage of gold and additional

supplies of currency are obtained by selling gold for notes to the currency authorities. Similarly demands of gold whether for internal consumption or for making foreign payments are met by purchasing gold for notes from the currency authorities or market. The currency unit in whose terms the values of all commodities and services of the country are expressed and against which all of them exchange is really gold though indirectly. Similarly prices of all commodities and services of the country are really gold prices though indirectly. This position of the currency unit of a country gives it the name of gold bullion standard.

It should be noted that though this system has come into practice only recently yet a currency system of this type was advocated by Picardo in 1816 during the bullionist controversy. Adam Smith was the first to conceive the benefits that would accrue to the people of a country by substituting paper notes in place of the expensive gold media of circulation. Adam Smith's idea that if a wagon way in the air could be constructed as a means of transport, it would allow the conversion of a large part of the roads into fields and meadows was utilised by Picardo who advocated an ideal monetary system under which precious metal money would be entirely eliminated from domestic circulation. Domestic currency would consist of only paper notes which would be converted for all purposes not into gold coins but only into bullion at a fixed rate. Thus a large quantity of gold of a country which under gold currency standard remains frozen in the form of domestic currency becomes released under gold bullion and every other indirect gold standard system to be used by the country in a more productive way.

In Europe this system was first adopted in Great Britain by the Gold Standard Act of 1925. In that year Great Britain resumed gold standard but in this modified form and except the demands of gold at the Bank of England closed the mint to the public. Under this Act it was made obligatory for the Bank of England to redeem notes in unlimited quantities in gold instead of sovereigns at the rate of £ 3-17 10½ per ounce.

of standard fineness, and to purchase gold in unlimited quantities at the rate of £ 3-17-9 per ounce. On the model of Great Britain, France, U. S. A., Germany, Japan, etc., all these countries adopted a gold bullion standard later on. As compared to gold currency or direct gold standard, gold bullion standard possesses the great advantage of being economical, for the internal currency of the country consists of only paper and gold is kept only in the paper currency reserve. In order to secure sufficient confidence of the people in their currency system, gold is offered by the currency authorities against legal tender money both for export and domestic purposes, but only in quantities sufficiently big to save the currency authorities from meeting numerous small demands.

In India such a system of currency and standard had been recommended by the Hilton Young Currency Commission of 1926. The Commission had recommended, "the currency system which we recommend for the present needs of India may be described as a gold bullion standard. We propose that an obligation should be imposed by statute on the currency authority to buy and sell gold without limit, at rates determined with reference to a fixed gold parity of the rupee, but in quantities of not less than 400 fine ounces, no limitation being imposed as to the purpose for which the gold is required. The fulfilment by the currency authority of this obligation will secure the stability of the gold-value of the rupee, and the stability of exchange within the gold points corresponding to the selected parity. Gold is thus made the standard of value. The rupee is linked to gold and to sterling or to any other currency or group of currencies.

Since gold bars are to be given in exchange for notes or silver rupees, not for export only, but for any purpose, this is not an exchange standard; it is an absolute gold standard. Nevertheless the compensatory mechanism of the exchanges is preserved, because gold bars are not currency. When gold bars are given by the currency authority for notes or rupees, the currency is contracted, while on the other hand,

when gold bars are given to the currency authority for notes or rupees, the currency is expanded

For the purposes of India this standard fulfils the essential condition, that it should be not stable only, but simple and certain. It provides the token currency with a right of convertibility that is intelligible to the un instructed, and with a backing that is tangible and visible. In short, it has the characteristics necessary to inspire confidence in the Indian people, to promote the habits of banking and investment and to discourage the habit of hoarding precious metals. The statutory obligation to buy and sell gold for rupees without limit at a prescribed parity for the first time in the history of the rupee will base it on gold firmly and in a manner that is conspicuously visible. It establishes the principle that gold is the standard of Indian currency at a fixed ratio, and that the currency authority admits it and must maintain it"¹

It may be seen here that in their enthusiasm to emphasize their recommendation members of the Hilton Young Currency Commission called the gold bullion standard system as absolute gold standard. There is no doubt that gold bullion standard is gold standard, but not a direct or absolute gold standard, for the reason that in this system the standard or unlimited legal tender money is itself not made of gold, but is convertible into gold. Consequently it is natural that this system can not command that much of confidence of the people, as is the case with gold currency or direct gold standard, though in this respect it is certainly much better than gold exchange standard, gold currency exchange standard, etc.

Gold Exchange Standard—Theoretically gold exchange standard means a currency system in which the internal currency in circulation in a country consists of legal tender paper notes or silver coins or both, but their exchange value is fixed in terms of gold. The currency authorities of the country undertake the obligation to give gold in exchange of domestic currency, and domestic currency in exchange of gold surrendered, without limits, and at certain fixed rates.

1. Report of the Hilton Young Currency Commission 1926, p. 224

known as lower and upper gold points respectively. The external value of the country's currency is thus maintained between these two rates by the currency authorities, and in order to be able to do so they maintain a gold reserve fund out of which sales of gold are effected and to which purchases of gold are added.

Gold exchange standard is very much like gold bullion standard, but there is one very important point in which gold exchange standard differs from gold bullion standard. We have already seen before that under gold bullion standard the currency authorities of a country undertake the obligation of buying and selling gold bullion at fixed rates without limits, against the standard or legal tender money of the country, for whatever purpose the said concession may be demanded. There is a statutory obligation for the currency authorities to give gold for domestic currency, whether it is required for export or for internal consumption. In gold exchange standard system it is not so. Here currency authorities sell and purchase gold against domestic currency, only when it is required for settlement of foreign transactions.

Under gold exchange standard for all internal purposes paper notes or silver money both of which are token money are legal tender, and only for purposes of foreign payments their exchange value is a fixed quantity of gold. This is not a very suitable system for such a backing of the domestic token currency is too intangible and invisible. It is not intelligible to an average man. The fact that external value of their money is maintained at a rate much higher than its intrinsic value, through the mechanism of gold exchange standard and its reserve fund, can not easily be understood by the ordinary people. This is a great difference between gold bullion and gold exchange standards, and on account of this it is evident that the gold exchange standard system can not command that much of confidence of the people as is the case with the gold currency or gold bullion standards.

In gold bullion standard the internal currency of a country

may consist of mostly paper notes, still as compared to gold exchange standard it would command greater confidence, for under this system the link between internal currency and gold is sufficiently visible. People know that they can get their notes converted into gold bullion, whenever they like and for whatever purpose they want it. Thus they treat these paper notes as sufficiently reliable representatives of various quantities of gold. On the other hand in gold exchange standard the internal currency consisting of paper notes and other forms of token does not command sufficient confidence, for the people know that they can not freely get gold bullion in exchange of their notes for whatever purpose they like to have it. Here the link between gold and internal currency is neither solid nor conspicuously visible. Thus the people of such a country treat their currency as only an inconvertible paper standard, and with that consciousness they accord to it the same treatment.

Without some backing more certain, simple and solid, confidence in the exchange value of the currency standard of a country can not be sufficient to enable it to work efficiently and develop the habits of banking and investment. If however, in order to command sufficient confidence of the people, in any country gold exchange standard is combined with silver full legal tender money for internal circulation and gold and paper currency are legally convertible into silver coins without limits as has been the case in India from 1892, there is possibility of an additional difficulty. That difficulty is, that if at any time due to a great rise of the gold price of silver in the world markets, gold value of silver contents of the silver legal tender currency becomes higher than its fiduciary exchange value, the currency authorities will have great difficulty in converting gold or paper currency into legal tender silver money. Under such circumstances all efforts will have to be made to prevent the non-monetary uses of silver money such as its export, melting or hoarding. Ultimately if the difficulties are formidable the currency authorities may have even to stop payments in

silver money and substitute in its place small notes, and coins of nickel or of less silver content. This may lead to loss of confidence. During the post war years of the last Great War due to such difficulties the Currency Department of India issued Rs. 1 and Rs. 2½ notes and eight and four annas nickel pieces, and in certain parts of the country these money units did not command sufficient confidence and actually circulated at a discount and people suffered. Even during the present war owing to a high rise of the price of silver, the Government of India has issued one rupee notes and quaternary silver rupee, half-rupee and quarter-rupee coins which contain only 50 per cent. silver and are used in circulation with suspicion.

Another great disadvantage of gold exchange standard currency system is that it is capable of great manipulations. There is no doubt that even gold currency and gold bullion standards can be manipulated by the currency authorities of their countries to influence their exchange values in such a manner as to serve certain ends aimed at. This is quite evident from the recent currency history of the different countries of the world. Still it should be noted that as compared to gold currency and gold bullion standards, gold exchange standard can be manipulated more easily, for it is a very indirect gold standard system and thus the effects of its manipulations can not easily be visualised or understood by the people. Some idea of this can be had from the 1s. 6d. and 1s. 4d. controversy in India after the Hilton Young Currency Commission Report of 1926. A large body of public opinion in India is suspicious of gold exchange standard. It is convinced that this currency system can be manipulated very easily and the manipulation may be inconsistent with Indian interests. This fear can amply be justified by a comparison of the history of Indian currency with that of the other countries of the world.

Gold exchange standard system of currency is very defective. It is neither simple nor efficient. The only advantage possessed by this system is, that as compared to gold currency or gold bullion standard, it is economical for the reason that

in this system gold is used only in settlement of foreign transactions and internal currency is neither made of gold nor convertible into it for domestic purposes. One point which must be noted here is that theoretically gold exchange standard really means a currency system in which the currency authority of a country undertakes to buy and sell gold in unlimited amounts against the home currency. In practice however this is done only indirectly : i.e. through the currency of some other country or countries with a true gold standard. In India from 1898 to 1931 gold exchange standard was always worked through the pound sterling based on gold and the mechanism of its working consisted of council bills, reverse councils and the gold exchange standard reserve fund. This is really gold currency exchange standard rather than gold exchange standard. There is no doubt that so long as the currency or currencies of other countries into which the currency of the so called gold exchange standard country be convertible are based on a real gold standard there is no difference between gold exchange standard and gold currency exchange standard. But if at any time their currency or currencies are not on a real gold standard even if it be for a short period as was the case with English currency from 1920 to 1925 or again after 1931 there comes a difference between gold exchange standard and a gold currency exchange standard. In February 1920 the gold or gold exchange standard value of the Indian rupee was 2s while gold currency exchange value or value in terms of sterling was 2s 4d¹.

Gold Currency Exchange Standard—In this currency system the internal legal tender currency of a country consists of paper notes or silver coins or both but their external exchange value is fixed in terms of currency or currencies of other gold standard countries at certain fixed rates. The currency authority tries to maintain this external value by offering to buy and sell foreign gold currency or currencies in unlimited amounts against domestic currency of the country and for this purpose it maintains a reserve fund of such foreign currency or cur-

1 Hilton Young Currency Commission Report 1926 page 4

rencies. This is also an indirect gold standard for the country's standard money is not made of gold, but for purposes of external transactions only it is convertible into a currency or currencies that are of gold.

In practice under such a system the internal currency of a country is usually convertible into gold standard currency of only one foreign country and through that into the currencies of other countries of the world. Rarely the monetary laws of any country put an obligation on its currency authority to redeem the local currency statutorily into the gold currency of more than one foreign country. For example Indian currency since 1898 has been a gold currency exchange standard for the external value of the rupee has always been fixed in terms of gold sterling, and through that India maintained the external value of the rupee against the currencies of all other countries of the world.

A gold currency exchange standard is usually referred to as gold exchange standard, but this is not appropriate for the domestic currency is statutorily convertible only into gold currency of a particular foreign country, and not in gold. The holders of domestic currency can not claim gold in exchange as a right, but they can get the promised gold currency of the particular foreign country. In practice such a currency system is not much different from a gold exchange standard except, that in the latter system the country's foreign exchanges against all other gold standard countries are determined directly, while under the former system they can be determined only indirectly *i. e.*, through the exchange value of that country's currency in terms of which the value of domestic currency has been fixed.

Another important difference between gold exchange standard and gold currency exchange standard system is that the latter is a dependant currency system. In gold exchange standard system the foreign exchange value of the country's currency unit depends upon the quantity of gold per unit that has been promised to be given by the country's currency authority against domestic currency, and unless

this quantity is varied the foreign exchange value of the country's currency unit against other gold standard countries does not fluctuate. On the other hand the foreign exchange value of the currency unit of a gold currency exchange standard country against other countries of the world does not only depend upon the statutory foreign exchange value of the country's currency unit but also upon the foreign exchange value against other countries of the world of the currency unit of that country in terms of whose currency the external exchange value of the currency unit of the gold currency exchange standard country has been fixed.

For example suppose country A has a gold currency exchange standard system and the foreign exchange value of her currency unit is fixed in terms of the currency unit of B country. If this is so foreign exchange value of the currency unit of A country against other countries of the world will not only depend upon the statutory exchange obligation of the currency authority of A country but also upon the foreign exchange value of the currency unit of B country against those other countries. Thus if the foreign exchange value of the currency unit of B country against other countries of the world falls at any time the foreign exchange value of the currency standard of A country against those other countries will also fall down. On the other hand if at any time foreign exchange value of the currency standard of B country against other countries of the world goes up the foreign exchange value of the currency standard of A country being linked with that of B country will also go up against those other countries of the world. Thus we see that in gold currency exchange standard or dependant currency system the foreign exchange value of the currency standard of the dependant country may be affected: i.e. it may go up or go down though that may not be justified by her own currency or general economic conditions. This is a great defect of gold currency exchange standard or any other dependant currency system.

It should be noted that the gold standard or gold basis of

the currency unit of a gold currency exchange standard country depends upon the gold standard or gold basis of the currency unit of that country, in terms of whose currency the exchange value of the currency unit of the gold currency exchange standard is fixed. Thus so long as the currency system of the latter or principal country is on a gold basis, the currency system of the dependant country is also on gold basis. On the other hand if at any time voluntarily or due to adverse currency or economic conditions, the principal country goes off gold standard or the exchange value of her currency unit depreciates in terms of gold, the currency system of the dependant country will also automatically go off gold standard. The exchange value of her currency unit also will fall in terms of gold and the foreign exchange values of that country's currency standard against all other gold standard countries will become highly unfavourable or low.

Upto 1927 Indian currency system was a gold currency exchange standard, but from that date according to the Indian Currency Act of that year India adopted Sterling Exchange or a gold currency exchange standard. In September 1931 Britain went off gold standard. Consequently foreign exchange value of her currency standard i.e., sterling fell down in terms of all gold standard countries. Indian rupee being linked to sterling at 1s. 6d., its value also fell down in terms of currencies of all gold standard countries. During the economic crisis of 1929-32, it is not only Britain that went off gold standard, but many other countries of the world as well went off gold standard and devalued their currencies very heavily in terms of gold or gold currencies. Some of these countries devalued their currency units in terms of gold much more heavily than sterling. The result was that those currencies became much cheaper in terms of sterling as well as rupee linked to it. Consequently India's foreign trade suffered very much. Her exports fell down much more heavily than her imports, and a country which used to have very heavy favourable net balances of trade and used to import gold, had to export it amounting to about Rs. 300 crores in order to maintain the foreign exchange value of the rupee at 1s. 6d. sterling.

Thus we see that gold currency exchange standard such as sterling exchange standard or any other currency exchange standard is a dependant currency standard, and an account of that it has many serious defects. Under such a system as compared to the other standards the foreign exchange value of the currency standard of a country can not remain stable for any great length of time. Even the gold basis of the country's currency standard is uncertain under this system. This is clear from the sad experience of the Indian currency system and her sterling exchange standard from 1927 upto the present time. Indian currency today consists of a legal tender monetary unit, whose internal value depends upon the financial and credit policy of the currency authorities of the country, while her foreign exchange value depends upon the currency policy of the Government of India and the fate of sterling in the world currency and exchange systems. Such a currency system and standard is very artificial and capable of great manipulations. It is neither simple and intelligible to the people nor is certain in maintaining its value at stable rates either internally or externally. It is a system which can not command sufficient confidence of the people to develop among them a habit of credit and investment rather than suspicion and hoarding of precious metals.

The only advantage that sterling exchange standard or any other gold currency exchange standard system possesses is that as compared to other forms of gold standards, it is cheaper for under this system the internal currency of the country neither consists of gold coins like the gold currency standard nor lot of gold has to be kept in the currency reserve to be given away in exchange of domestic currency when demanded, as it is the case in gold bullion and gold exchange standard currency systems. Here the entire currency reserve of the country may be invested in interest bearing self-liquidating or easily convertible securities of the principal country in terms of whose currency the foreign exchange value of the currency unit of the dependant country has been fixed. This is the only great advantage of the gold currency exchange

This is commonly known as the paper standard, and is the result either of an excessive issue of inconvertible paper notes due to very adverse financial and currency conditions of the country or the outcome of a deliberate device to work some currency ideal. The former is said to be 'Forced Paper Standard' and the latter 'Voluntary Paper Standard'. Forced paper standard can again be sub-divided into 'Unmanaged Paper Standard', 'Managed Paper Standard' and 'Paper Currency Exchange Standard'.

Forced Paper Standards

Unmanaged Paper Standard—Unmanaged paper standard is one in which the currency authority of a country goes on issuing more and more inconvertible paper currency keeping little or no reserve behind it. The result of this is that ultimately the currency standard of the country does not possess any substantial internal or external exchange value. Prices of goods produced inside the country and imported from abroad both rise to astronomical figures. Exchange value of the currency standard falls down to infinitesimal fractions and currency system of the country becomes beyond repairs and is ultimately left to its own fate. This was the position of German currency system after the last World War until stabilisation in December 1923. Later on paper mark was given up and it was replaced first by Renten-mark and next by Reichs-mark in October 1924. Such a currency system paralyzes the entire currency and economic structure of the country and it takes a long time to replace it by a suitable system.

Managed Paper Standard—The other type of forced paper standard is the managed paper standard. Here also the country goes off gold standard and its paper currency becomes inconvertible, but one important point in which this system differs from the other or unmanaged paper standard is that in this system the currency authority of the country does not withdraw its entire support from the currency and leave it to its fate. The currency reserve of the country does not become absolutely worthless. No doubt due to heavy

withdrawals and adverse financial condition the metallic portion of the paper currency reserve of the country becomes insufficient to redeem on demand all paper currency offered, but the currency authority has some metallic reserve and realisable securities out of which it can redeem the currency issued at some figure lower than 100 per cent.

In this system also as the country goes off gold standard and its paper currency becomes inconvertible, prices of all internal and external goods begin to rise high. Foreign values of the country's standard become very adverse or unfavourable. There is a constant fluctuation of the exchange value of the monetary standard both internally and externally, yet there are limits beyond which neither the foreign exchange values do fall nor the internal level of prices does rise. Thus a forced and managed paper standard is only a temporary currency difficulty having behind it a constant effort of the currency authority to stabilise the internal price level and the foreign exchange values either at the old rate or at a new gold parity.

Great Britain, which was on a gold bullion standard before September 1931, gave up that standard from that date due to inadequacy of metallic currency reserves and heavy withdrawals of short period funds from London by the continental countries of Europe. Consequently from September 1931 Britain went off gold standard and her currency became a forced paper standard. For some time the pound sterling was left to its own fate, but management was soon taken up. It may be said to have begun with the creation of the Exchange Equalisation Account in July 1932. Thus from July 1932 Britain may be said to have adopted a managed paper standard, for from that date it tried to prevent heavy fluctuations in the exchange value of her currency either internally or externally. Britain tried to maintain the external exchange values of her paper standard through exchange equalisation fund, exchange agreements, deflation and other devices: and since June 1935 the gold value of pound sterling became more or less stationary at a little over 60 per cent. of its original value.

A comparison of these two standards an unmanaged paper standard and a managed paper standard shows that the latter is better than the former for it does not permit the economic structure of the country to break down completely into a hopeless disorder, though none of them is a currency system which is devised from the beginning to be introduced as such. A forced paper standard crops up only as the result of the country's very heavy expenses due to war or such other calamity on account of which the metallic portion of the currency reserve of the country becomes highly depleted and the invested portion of the reserve becomes unrealisable. Consequently currency becomes inconvertible its value falls prices rise high, credits become damped, trade and industry are paralysed and the country as a whole suffers.

Paper Currency Exchange Standard—This is a currency system in which internal currency of a country consists of paper notes and metallic coins but the external exchange value of the standard money of the country is fixed in terms of currency of another country which is off gold standard at that time. The currency authority maintains the relation so fixed between the home and foreign currency by buying and selling the latter against the former in unlimited quantities at rates based upon that fixed ratio. From 1927 i.e., after the Indian Currency Act of that year, India adopted a sterling exchange standard and rupee was linked to sterling at 1 s 6 d., instead of gold, but as at that time Great Britain was on gold bullion standard, the Indian Sterling Exchange Standard was indirectly a gold exchange standard. On September 21, 1931 England went off gold standard and by an ordinance of the Government of India of that date the above link was suspended, but by Ordinance VII of September 24, 1931 Government of India restored the rupee-sterling link. Thus from September 24, 1931 when the Government of India restored the rupee-sterling link and upto June 1935 by which date Great Britain again practically stabilised her currency in terms of gold, India remained on a paper exchange standard. Theoretically even today Great Britain is off gold standard and is working on a Managed

Paper Currency Standard, and as such at present also statutorily India has a Paper Currency Exchange Standard.

In effect paper currency exchange standard is not very much different from paper standard. It has all the defects of a paper standard and in addition to them the standard being linked to a foreign currency, it also suffers from all the disadvantages of a dependant currency. Changes in exchange value of the foreign paper currency are also passed on to the currency linked to it. Consequently this currency system is neither certain in its internal or external exchange value to help trade and industry, nor simple to command confidence of the people. It suffers from almost all the possible defects of a bad currency system. Strictly speaking it is not at all a sensible system. Except that it may be adopted by a dependent currency for only a short period taken by the principal country in stabilising her currency, it can not at all work suitably in any country.

Voluntary Paper Standard

As opposed to forced paper standard, voluntary paper standard is a currency system in which the currency authority of a country gives up gold or silver standard and adopts a paper standard in spite of possessing adequate currency reserves. This is done by demonetising a large portion of the *metallic reserve of the country by statute*. A country may go off gold standard voluntarily for reasons of economic strategy. If at any time a country is on gold standard while others with which it mostly trades go off gold standard, there arises a great difficulty in their trade relations. In such a case the value of currency of the gold standard country rises very much in terms of currencies of the countries that are off gold standard. Consequently prices of all goods produced in off-gold-standard countries in terms of currency of the gold standard country fall very much or become very cheap. On the other hand prices of goods produced in gold standard country become very high in terms of currencies of the countries that are off gold standard. The result of this is that exports from gold standard country are seriously checked while

imports into it are much encouraged. Consequently all export industries of the country suffer and there is a great depression and unemployment in them. Moreover due to a heavy unfavourable net balance of trade the country's gold holding is fast reduced and the gold basis of its currency system is seriously endangered. In order to check the efflux of her gold and to protect her industries, the gold standard country has to adopt a number of artificial devices such as an embargo on the export of gold, custom duties, trade agreements etc. When these devices also fail or prove insufficient to protect her industries and gold stock, the country goes off gold standard by withdrawing from the public its statutory undertaking to give gold coins, gold or gold equivalent in exchange of domestic paper currency at the fixed rate. This means going off gold standard and adopting a voluntary paper standard.

Under conditions similar to those described above U S A adopted a voluntary paper standard in March 1933. It should be noted that adoption of a voluntary paper standard in place of a gold standard is a step taken by a country in self defence due to the break-down of the international gold standard. An international gold standard currency system works smoothly under the presumption that if prices rise unduly in one country, in course of time that country's balance of trade becomes an unfavourable one and the country is exposed to an outward drain of gold with its consequential pressure on its price level to be restored in course of time at its old level. But it should be noted that if in any country the incoming gold is not used for monetary purposes but is hurried in the vaults of the Central Bank, there will be no rise of internal price level, no unfavourable balance of trade, and consequently no reversal of the movement of gold. It is to protect against such a mismanagement of gold standard and the blockade against the automatic working of the gold standard that a country which may have been on a gold standard may have to go off gold standard and adopt a forced or voluntary paper standard.

Both forced and voluntary paper standards are temporary

devices to overcome certain difficulties. A forced managed paper standard is a temporary device to overcome the difficulties of the inadequacy of metallic currency reserves and general financial embarrassments. Similarly a voluntary paper standard is a temporary device to meet the undesirable competition of gold standard countries in the sphere of international trade and industry. Thus both of these paper standard systems give only a temporary incentive to trade and industries of the countries which adopt them. Ultimately countries going off gold standard and adopting paper standards forced or voluntary have to stabilize their currencies in terms of gold, though it may be at a lower parity than before.

Gold Cum. Tabular Standard

An important function of money or currency of a country is to act as a standard of deferred payments. This necessitates that the exchange value of money should not fluctuate very widely from time to time. A change in the exchange value of money from time to time implies that other things remaining the same, the borrower of money pays back either more or less purchasing power than what he should actually pay back to the creditor. There is no doubt that apparently in such cases, leaving interest, the borrower pays back to the creditor the same number of units of currency which he had actually borrowed; but in reality if the exchange value of money is higher or lower at the time of repayment as compared to the time of taking the loan, the borrower pays back more or less than the amount he had actually borrowed. As such either the borrower or the lender suffers unnecessarily. One party obtains an unearned increment and the other party suffers an unearned decrement.

Suppose A borrows from B Rs. 10 when the value of rupee is x in terms of general commodities, and repays them at a time when the value of the same is $5x/4$. Here at the time of borrowing A actually gets from B $10x$ and at the time of repayment, besides interest, by paying back Rs. 10 he actually repays $50x/4$. Thus in terms of general commodities the

difference between the amount actually borrowed and repaid is $50x/4 - 10x$ or $5x/2$. In this example we see that owing to a rise in the exchange value of the rupee from x to $5x/4$, the borrower actually suffers a loss of $5x/2$ and the creditor gains an unearned increment of an equal amount i.e., $5x/2$. Consequently if the value of currency of a country is liable to such wide fluctuations, credit development specially of long term shall be seriously discouraged and trade, commerce and banking would seriously be hampered in their growth.

The currency standards of different countries of the world both of gold and silver have shown in the past such wide variations in their purchasing powers at different periods of time that a few important economists grew dissatisfied with the use of gold or silver as money for any country and tried to enunciate a standard which would work more equitably between debtors and creditors, and variations in whose value from time to time would correspond more appropriately with changes in the economic conditions of a country.

One of the standards suggested for this purpose is Prof J. M. Keynes gold cum, tabular standard. It is an alternative to a gold, silver or paper standard to be used only in making deferred payments or in respect of settlement of transactions involving a period of time, in order to insure equity among debtors and creditors and remove the difficulty caused by fluctuations in the exchange value of money between the time of borrowing and repayment. Under this standard an attempt is made to return to the creditor the same quantity and quality of goods, which were actually lent by him at the time of giving the loan and thereby remove the injustice that may be caused either to the debtor or the creditor owing to a rise or fall in the exchange value of money between the time of giving the loan and the time of its repayment.

The tabular system proposes to constitute a standard for a country from the prices of a large number of articles of general use. In order to fix the value of the standard, first of all a number of articles of general use should be selected and their

wholesale prices should be ascertained. For this average prices of a suitable period—a week, a month or a year should be calculated, and from them should be found out the price of one unit of general commodities. When this has been done the price of one unit of general commodities in terms of standard money of the country should be supposed as 100 and this should be fixed as the basis for comparison in future in order to find out the rise or fall of the exchange value of standard money in terms of general commodities or in ascertaining the number of units of standard money, which in their purchasing power at any future time are equal to one unit of the standard money of the basic period. After this has been done it can easily be found out as to how many units of the standard money should be given back by a debtor to his creditor in exchange of a certain number of standard money units borrowed by him at any past time, which is taken as the basic period for the transaction.

For example suppose A borrowed from B Rs. 100 in 1925 and wants to repay them in 1935. Now in order to ascertain the exact number of rupees which A in 1935 should return to B in order to pay back the debt of Rs. 100 borrowed in 1925 without any loss to himself or to B, *i.e.*, returning to B the same number of units of general commodities as were actually borrowed by him, the following procedure should be adopted :—

Names of Commodities.	Prices in 1925			Prices in 1935		
	Rs.	as.	p.	Rs.	as.	p.
Rice per maund	5	0	0	4	0	0
Wheat per maund	4	8	0	3	0	0
Sugar „ seer	0	6	0	0	4	0
Milk „ „	0	4	0	0	2	6
Pulse „ maund	4	0	0	3	0	0
Salt „ seer	0	2	0	0	1	3
Ghee „ „	1	8	0	1	0	0
Rs.	15	12	0	11	7	9
Average price of one unit of general commodities.	2	4	0	1	10	3
Suppose 1925 is the basic year.			100	73	approxi-	
Thus general commodities which could be purchased in 1925 for Re. 1 can be purchased in 1935 for Re. '73.			1		'73	

This Re. 73 should be taken as the basis or standard for repayments in 1935 of all debts incurred in 1925, i.e., for every rupee borrowed in 1925 the debtor in 1935 should pay back only Re. 73. According to this basis or standard excluding interest if in 1935 A pays back to B Rs. 73 in payment of a debt of Rs. 100 taken in 1925, there will not be any unnecessary loss to the debtor A or any unearned increment to the creditor B. By paying back Rs. 73, A will really return to B the same quantity and quality of goods which he had actually borrowed and the transaction would be settled very equitably.

In fixing the value of the standard money of any country in this way, care should be taken to see that the articles selected are fairly representative of the general consumption needs of the people of that country, and for this purpose the list of the articles selected should be a fairly long one. Further of these articles those quantities should be selected, which represent a true proportion in which they are generally consumed by the people. The units of quantities and the nature of prices preferably wholesale should be adhered to. Collection of prices should be done by a government department and they should be averaged weekly, monthly, quarterly, half-yearly or yearly, whichever may be considered as suitable. The exchange value of the standard ascertained according to the above procedure should be declared by a government notification from time to time. This is in brief the gold cum tabular standard. It should however be noted here that under this standard, for ordinary daily transactions the medium of exchange remains the same metallic or paper standard, but only for purposes of deferred payments the value of the standard money is so ascertained from time to time in terms of general commodities of the country and that is used in settlement of those transactions.

An important defect of this system is that it may fail to achieve that very end which it aims at. It aims at equity in transactions of deferred payments by giving back to the creditor the same quantity and quality of goods which were lent

by him. In this system changes in the exchange value of standard money are ascertained by means of prices. Prices depend upon exchange value of money as well as utility of commodities. It is possible that the same quantity and quality of goods at the time of repayment of the loan may not represent the same amount of utility that they possessed at the time the loan was granted, and as such either the creditor may get back less utility than that which he actually lent or may get back more than that. Thus in this standard also there are possibilities of inequity.

The same quantity and quality of goods to two different persons at the same time do not in many cases give the same utility, because of the differences in the nature and proportions in which the different commodities enter their lists of articles of consumption. Thus in this system the assumption that different articles whose prices are collected to ascertain the value of the standard, have same utility both for the debtor and the creditor, and as such by returning to the creditor that amount of money which might be able to purchase at the time of repayment the same quantity and quality of goods, which could be purchased by the amount borrowed at the time when the loan was granted, is no guaranty that to the creditor has been returned the same amount of utility which he had lent, unless the articles taken in the list and the proportions of their quantities are true representatives of the nature of consumption of the debtor as well as the creditor.

Suppose in case of the creditor meat plays an important part in his list of articles of consumption, while in case of the debtor it does not play such an important part, and as compared to 1925 in 1935 the prices of all other commodities have fallen, but the price of meat has risen. Thus if fall in the prices of other commodities is compensated by the rise in the price of meat, the exchange value of the standard money as expressed in terms of general commodities at the two periods 1925 and 1935 will not show any substantial difference and it shall be concluded thereby that excluding interest, if in 1935 A gives back to B, one hundred rupees in repayment of the

same amount he borrowed in 1925, none of the two parties shall gain or lose any unearned increment or decrement. But it is evident that by paying back rupees one hundred the debtor gives back to the creditor really much more than the quantity and quality of goods that he had actually borrowed, because the prices of all other commodities in which he spent his money have gone down, while the price of meat in which he did not spend any large fraction of the money borrowed, has gone up. On the other hand the creditor on getting back Rs. 100 in 1935 in exchange of Rs. 100 lent in 1925 does not get back the same quantity and quality of goods that he had actually lent because though the prices of all other commodities have gone down yet the price of meat in which he generally spends a big portion of his money has considerably gone up. Consequently he does not get back the same quantity and quality of goods which he had actually lent. He gets less. Thus the debtor suffers a loss from his point of view, while the creditor suffers a loss from his point of view and the transaction can not be said to have been settled very equitably by adopting the use of the tabular standard. The debtor pays back to the creditor more than the quantity and quality of goods which he had borrowed while the creditor receives back less than the quantity and quality of goods that he had lent. Consequently it is not equitable and can not be so unless the articles selected for ascertaining changes in the exchange value of the standard money truly represent the nature of consumption of the two parties. Thus it can not be said that repayments of loans on the basis of a tabular standard shall always be very equitable.

Another defect of this system is that it is very abstract, uncertain and complicated. It aims at bringing equity among the debtors and creditors and thereby develop credit and confidence in the country. It tries to insure to the creditor that he would get back at the time of repayment of the loan, the same quantity and quality of general commodities which he actually lends at the time of giving the loan. But it should be noted that credits are usually granted and repaid through

the medium of money. Under this system when a creditor lends Rs. 100, he is not sure at that time as to how many units of standard money or rupees he will get back at the time of repayment of the loan. Similarly when a person borrows Rs. 100, he is not sure at that time as to how many rupees he will be called upon to give back to the creditor in payment of the principal sum at the time of repayment of the loan. There is no doubt that both parties are sure that they will get back and give back the same number of units of general commodities, but this is not enough. Here one does not know what number of rupees one will actually get back or will have to give back at the time of repayment of the loan. This is a great uncertainty and shall check the development of credit, instead of encouraging it.

In all credit transactions money borrowed or repaid is not immediately used for consumption. Thus when money is received in deposits in banks or is lent out by banks, the risk of changes in the value of money during the periods of credit shall lie on the shoulders of bankers and they can never be sure of their financial position unless they realise all their loans and repay all deposits. Moreover there will be a tremendous difficulty to banks' depositors to understand the real position and solvency of their banks. Thus all these factors shall seriously check the development of credit of a country, which the tabular standard really aims at developing.

In addition to the above defects this system of enforcing the exchange value of the standard money for making deferred payments in any country requires an elaborate, honest and expensive government machinery to collect commodity prices continually in order to ascertain the true exchange value of the standard at different times. Moreover this system is far from being simple and intelligible to the ordinary people. These are great defects. Consequently the tabular standard system is full of grave dangers and suffers from the greatest defect of impracticability and for these reasons no country of the world ever adopted it.

4 Stabilised Paper Standard

This is also a currency proposal to remove the injustices caused to debtors and creditors in credit transactions or deferred payments and other difficulties due to fluctuations in the exchange value of money in terms of general commodities. The stabilised paper standard aims at removing that difficulty which the gold cum tabular standard proposes to cure. This scheme was first suggested by Professor Irving Fisher¹ before the last Great War. Under this plan all gold dollars are to be withdrawn from circulation and in place of them are to be issued paper certificates entitling their holders to receive in exchange per dollar such weight of gold bullion as may be officially declared to constitute a dollar on that date. The gold bullion exchange equivalent of a dollar on any date is to be determined in accordance with changes in the exchange value of the dollar in terms of general commodities on the basis of prices.

For this like the tabular standard a particular normal year is to be selected and of that year average exchange value of a dollar in terms of general commodities is to be calculated. Now this should act as the basis and in future the exchange value of the currency standard at any time in terms of general commodities should be similarly calculated and compared with the base year and the change ascertained in terms of percentage. If the exchange value of the currency standard on any future date compared to the base year rises the gold bullion exchange equivalent of the currency unit should be proportionately reduced. On the other hand if compared to the base year the exchange value in terms of general commodities falls, the gold bullion exchange equivalent of the currency unit should be proportionately raised. Thus the gold bullion exchange equivalent of the currency standard of the country should constantly rise and fall in accordance with the changes in its exchange value in terms of general commodities and in this way the country's standard should be enabled to command always the same purchasing power.

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The inequity and hardship caused to debtors and creditors owing to fluctuations in the exchange value of money in terms of general commodities shall thus be removed in this system. By paying back the same number of paper dollars the debtor shall always pay back to the creditor the same quantity of goods as were received by him at the time of taking the loan, for a rise in prices would at once be checked by an addition to the metallic exchange value of the currency standard and a fall of prices by a deduction from it. In this way the stabilised paper standard shall act as a suitable and efficient medium for the settlement of deferred payments and thereby encourage the development of credit in the country.

We see that both the gold cum. tabular standard and the stabilised paper standard aim at removing the same defect of the currency system of a country *i.e.*, the difficulty caused by the instability of the exchange value of the country's currency standard in terms of general commodities. The tabular standard tries to do it by authorising the increase or reduction in the number of units of standard money that can be given in settlement of a debt incurred in the past. On the other hand the stabilised paper standard or compensated dollar system, as it was named by Prof. Fisher, tries to do it by increasing or reducing the gold bullion exchange value of the country's currency standard in accordance with the fall or a rise of its exchange value in terms of general commodities.

It should be noted that like the tabular standard, the stabilised paper standard also is not free from serious defects. First of all it is a paper standard. People will have no gold currency in their hands. Then the gold bullion exchange value of the paper money shall always be fluctuating in accordance with the fluctuations in prices of general commodities. Thus at one time one paper dollar will give in exchange one quantity of gold and at another time a different quantity. It is therefore very doubtful whether such a paper currency system, which is capable of great manipulations will command sufficient confidence of the people and work as good money and develop the credit system of the country.

5. What is a voluntary paper standard? How does it differ from a forced paper standard? Explain.

6. Describe briefly the gold cum. tabular standard as suggested by Prof. J. M. Keynes.

7. Explain clearly the function of money which the gold cum. tabular standard aims at performing in an ideal manner. How far is it possible for it to do that satisfactorily?

8. Give a brief outline of Prof. Irving Fisher's scheme of stabilised paper dollar standard and point out its main defects.

CHAPTER V

INDIAN MONETARY STANDARD

In order to appreciate properly the present position of the Indian Currency System, it is necessary to study the background out of which the present system has evolved. The history of Indian Currency System can conveniently be divided into two parts *i.e.*, (1) the history of monetary standard in India and (2) the history of paper currency in India. Here it is proposed to deal with the history of monetary standard in India.

History of Monetary Standard in India

Parallel Standard—Before the establishment of British rule in India under East India Company, there was no uniform currency standard for the whole country. The country was divided into several kingdoms under different rulers and they had different currency standards in their territories. Mohammedan rulers of Northern India had in their kingdoms silver standards, while in circulation there existed also gold coins. In the territories of Hindu Rajas of Southern India there existed gold standards with gold and silver coins both in circulation. These gold and silver standards had no fixed legal ratio and exchanged for each other according to the market relation of their intrinsic values. Thus the East India Company found about 994 kinds of gold and silver coins of different weights and fineness circulating throughout the country and exchanging for each other or against other commodities according to their intrinsic or market values. The country had a double or parallel bimetallic standard

system and nobody could be sure of the value of the coins he held. The people had great difficulty in carrying on their trade transactions, and in order to make even moderate payments parties were compelled to use the services of professional money changers to declare the value of each coin¹.

Pure Bimetallism—This chaotic condition was found extremely troublesome by the East India Company in its revenue collections and business transactions. Consequently in the beginning of the 19th century the Company tried to introduce a pure bimetallic currency system with its own gold and silver coins of definite weights and fineness to exchange against each other at a fixed legal ratio. But owing to fluctuations in the market values of the two metals it was found impossible to maintain the legal ratio. Thus on account of difficulties of pure bimetalism, in 1835 the East India Company adopted a monometallic currency system with silver rupee of 180 grains troy (165 grains pure silver and 15 grains alloy or 11/12th fine) as the standard coin and unlimited legal tender throughout the Company's territories. The mints were thrown open to the free coinage of silver rupees and the Indian Currency System became a silver monometallism instead of bimetalism which prevailed so far.

Silver Standard—From 1835 to 1893 the Indian Currency System was a monometallic system with silver as the standard of value and a circulation of silver rupees and notes based thereon. With the opening of new and very productive silver mines in the United States of America and demonetization of silver by several countries of Europe such as Germany, Sweden, Norway, Denmark, etc., the supply of silver in world markets increased very much and its value fell very heavily. On the other hand owing to the introduction of gold as the only standard in several countries of Europe and United States, the demand of gold increased very much. The result of these factors was that depreciated silver metal began to flow into silver standard countries on a huge scale and gold value of silver fell all the more heavily.

Year.	Price of silver per oz.
1875	58d.
1879	52½d.
1888	43d.
1892	37½d.
1899	27d.

With the depreciation of gold value of silver the gold exchange value of Indian silver rupee began to fall heavily. The result was that the value of silver rupee which in 1871 was somewhere in the neighbourhood of 2 shillings of the English Gold Standard fell continuously till in 1892 it reached the neighbourhood of 1s. 2 d. Such a fall in the value of the rupee was harmful to trade and Government of India finances. Every year the Government of India had to spend a substantial sum in sterling gold pounds known as Home Charges on account of payment of interest on public debt or repayment of capital, salaries of officials on leave, pensions of retired officials, payments for stores purchase for the Military and Railway Departments, etc. Owing to the heavy fall in the gold value of the rupee, the number of rupees required to satisfy these payments rose very heavily. This alarmed the Government of India very much for it became necessary to increase public revenue by enhancing taxation very highly. To avoid this enhancement of taxes it was decided to take steps to raise and fix permanently the gold value of the rupee for purposes of exchange. The whole problem was considered by Herschell Committee appointed for the purpose, and on the basis of its recommendation it was decided in 1893 to close the mints to the unrestricted coinage of silver rupees.

Stopping free coinage of silver rupees led to a gradual divergance between the exchange value of the rupee and the gold value of its silver contents. Government stopped to add rupees to the existing circulation, though they remained unlimited legal tender and the standard of value for all internal transactions. As the Government ceased to add rupees and nobody else had the power to coin rupees, the exchange value of the rupee began to rise and by 1898

it became nearly one shilling and four pence. It should be noted here that the currency position from 1893 onwards was avowedly provisionary and transitional and some definite action still had to be taken, for owing to the closing of the mints by 1898 the people of the country had already begun to suffer on account of stringency of money. For these reasons a second currency committee was appointed in 1898 under the Chairmanship of Sir Henry Fowler to consider what further steps could be taken to reorganise the currency system of the country in order to establish ultimately a gold standard for India. The report of this committee marked the fourth stage in the history of Indian monetary standard. The Fowler Committee considered various proposals with regard to the problem of a suitable standard for India. The first of these was that of the Government of India. By 1898 the Government of India had come to the conclusion that silver should definitely be demonetised and that steps should be taken to establish in India a gold standard. For this the Government proposed that :—

(1) Money should be borrowed in England and part of it should be remitted to India in the form of gold to serve as the nucleus of a gold reserve.

(2) A certain number of rupees should be withdrawn from circulation and melted in order to raise the gold value of the rupee to 1 s. 4 d.

(3) The silver bullion obtained by melting down the rupees should be sold for gold which should be added to the reserve.

(4) Government should not part with any gold in their possession until the exchange value of the rupee had risen to 1 s. 4 d. Till then gold was not to be made legal tender in India, though this was to be the future goal of the currency policy.

The Committee rejected the above proposals on the grounds, that firstly they did not agree with the Government that the rise in the exchange value of the rupee was entirely due to the contraction of currency, and secondly that such an action would accentuate the stringency of money

were coined, there was every probability of maintaining the value of the rupee at the ratio decided upon.

(5) That Government should continue to give rupees in exchange for sovereigns or gold, though it should not be bound by law to give gold in exchange of rupees for internal purposes, for the undertaking of such an obligation would be inconvenient as it would impose on the Government a liability to procure gold in case of sudden demands at a heavy cost and to an extent which could not be foretold, though when the exchange fell below the lower specie point, the Government of India should as far as possible make its gold available for foreign remittances particularly when the balances of trade were against India.

(6) That in order to secure the convertibility of the rupees into sovereigns or having sufficient gold for making it available to the public for foreign remittances, the profits on any future silver coinage undertaken by the Government should not be treated as ordinary revenue of the Government, but credited to a gold fund to be kept in India as a special reserve, entirely apart from the Paper Currency Reserve and the ordinary Treasury balances. It should be noted here that the cost of coining rupees at that time was approximately eleven pence and half-penny and according to the exchange rate fixed they were to be sold to the public at the rate of one shilling and four pence. Thus the profits on the coinage of rupees were considerable.

(7) That when the Government had accumulated a sufficient gold reserve, and that so long as gold was available in its treasury, it might discharge its obligations in India in gold instead of rupees.

Thus we see the Fowler Committee held that a stable exchange could be secured and guaranteed only by adopting ultimately an effective gold standard. But as a temporary measure for the period of transition they accepted as their model a limping standard under which both gold and silver coins were to be unlimited legal tender with a fixed legal

the Gold Standard Reserve Fund was set up out of the profits of rupee coinage, which the Government resumed on a considerable scale in 1900; but instead of holding the reserve in gold coins or bullion in India as had really been recommended by the Committee, it was decided by the Secretary of State that it be invested in London in British securities. It was thus not in a liquid form nor easily convertible into gold. A portion of the reserve was also utilised for purposes of purchasing rolling stock for Indian railways. These practices gave rise to conditions which were never contemplated by the Fowler Committee. For the Home Charges which at this time amounted to about seventeen millions sterling a year, the Secretary of State acting on behalf of the Government of India sold Council Bills against gold deposited with him in London. These bills when presented in India were cashed at the Government Treasuries. Thus a part of the favourable balance of trade of India was liquidated through these Council Bills, while the surplus remaining after that was liquidated by importing gold or bullion, which therefore began to accumulate in the country in large quantities.

Gold Currency Exchange Standard—From 1904 the Secretary of State for India began to sell Council Bills on India without limit at the rate of 1 s. 4½ d. per rupee i. e., the gold export 'point' from England. The effect of this policy of keeping open a standing offer was that export of gold from England and import into India was checked, for it was generally more convenient to deposit gold in London and obtain Council Bills than to export gold to India. This system worked well until 1907-08, when failure of rains in India and financial stringency all over the world made the external exchange value of the Indian rupee very low due to a fall in her export trade. At this time there was as such a great demand for Reverse Council Bills, but the Government of India refused to sell them, for holdings in the Gold Standard Reserve Fund in England were mostly in the form of British securities, which could not be realised easily and thus these Reverse Council Bills could not easily be paid out of that fund, which was really contemplated by the Fowler Committee

as one of the objects of this reserve fund. Thus the external exchange value of the rupee began to fall and it came down to 1s 3 $\frac{1}{2}$ d. Ultimately the authorities in India had to give way and it was decided to sell in India a certain quantity of Sterling Reverse Council Bills on London at 1s 3 $\frac{1}{2}$ d representing the gold export point or equivalent to the cost of exporting gold from India. These bills were met in London from the funds in the Gold Standard Reserve Fund. These sales of Reverse Councils regularised and readjusted the position. In the meantime the Indian export trade also recovered.

The main feature of the Indian Currency System of that time was the gold currency exchange standard fixed at 1s. 4d. per rupee and maintained through a policy of selling without limit Council Bills or Reverse Council Bills as time and opportunity demanded at the import and export gold points to and from India, managed through the Gold Standard Reserve Fund kept with the Secretary of State on behalf of the Government of India and created out of the profits of coinage of rupees at a cost of about 11 $\frac{1}{2}$ d and put in circulation at a ratio of about 1s 4d. The Indian Exchange rate was maintained between these artificial export and import gold points so created and maintained by the administrative policy of the Government of India though not defined anywhere in any law book. This was usually called the gold exchange standard system of India and continued up to 1913.

In 1913 was appointed the Chamberlain Commission to enquire whether the then existing practice in currency matters was conducive to the interests of India. The Commission in para: 223 of their report acknowledged that the Fowler Committee had recommended gold exchange standard only as a temporary measure and really aimed at a gold standard with gold currency in active circulation as an essential condition of the maintenance of the gold standard in India, but further they stated that the history of the past fifteen years had shown that a gold standard system had been firmly established without an active circulation of gold currency. Thus on the basis

of the history of that short period of 15 years in which really no incident of any very serious and extraordinary nature happened, which could materially affect the currency or exchange situation of India ; the Commissioners believed that what had really been recommended by the Fowler Committee as merely a temporary measure, could work as a permanent currency system of the country. This shows that the weakness of the system of which the Fowler Committee were conscious was lost sight of by the Chamberlain Commission owing to the fact that except a little trouble in 1907, the system worked without any serious difficulty during that short period of 15 years. Truly speaking during this period except the crisis of 1907 nothing happened which could put the system to a really strict test to find out whether the system was suitable or not.

On the basis of such a deceptive data this Commission went so far as to recommend that ; (1) it was not to India's advantage to encourage an increased use of gold in internal circulation ; (2) the people of India neither desired nor needed any considerable amount of gold for circulation as currency ; and the currency most generally suitable for the internal needs of India consisted of rupees and notes ; (3) a mint for the coinage of gold was not needed for purposes of currency or exchange, but if Indian sentiment genuinely demanded it and the Government of India were prepared to incur the expense, there was no objection in principle to its establishment either from the Indian or from the Imperial standpoint ; provided that the coin minted was the sovereign or the half-sovereign ; and it was pre-eminently a question in which Indian sentiment was to prevail ; (4) the Government was to continue to aim at giving the people the form of currency which they demanded, whether rupees, notes or gold, but the use of notes was to be encouraged ; and (5) the internal currency was to be supported for exchange purposes by a thoroughly adequate reserve of gold and sterling.

Thus on one side the Chamberlain Commissioners recommended the continuance of the gold currency exchange

standard and on the other side they were conscious of the fact that the form of currency system suitable for a country was pre eminently a question of sentiment of the people of that country which really went a great way in building or annihilating the confidence of the people in the currency system of their country and which should be an important feature of any sound currency system Before any action could be taken on the recommendations of this Commission the last Great War broke out and the system followed in and after 1914 was the same old Gold Currency Exchange Standard

The War of 1914-18 put the currency system of India as also those of the other countries of the world to a severe test Gradually as war years rolled on the price or gold value of silver began to rise to unprecedented heights and with the rise in the price of silver the gold exchange value of the silver content of the rupee also began to rise and the Government experienced the difficulty of continuing their offer of giving silver rupees in exchange of gold at the established rate of Rs 15 to a Sterling Pound The rise in the price of silver took to such heights that the gold value of silver contained in the rupee became much higher than the official rate of 1s 4d per rupee The Government tried to maintain the external value of the rupee at the same official rate of 1s 4d but finding it impossible the Government let loose her reins and allowed it to follow the course of fluctuations of price of silver Thus the external exchange value of the rupee rose very rapidly and in December 1919 it reached 2s 4d sterling

In May 1919 was appointed a committee under the chairmanship of Babington Smith to examine the effect of the Great War on Indian exchange and currency system and practice and to recommend the policy that could be pursued to ensure a stable gold exchange standard in the light of the then and future variations in the price of silver It should be noted in this connection that in May 1919 when the Committee was appointed the price of silver was so high that the

external exchange value of rupee was 1s. 8d. and by the time the Committee gave its report in February 1920 the exchange value of the rupee had risen to 2s. 4d. Further it is very important to note here that the terms of reference of this Committee restricted the scope of its enquiry and recommendations. The Committee had been asked to recommend steps that could be taken with a view to maintain a satisfactory monetary circulation and ensure a stable gold exchange standard. Thus the Committee had been precluded from considering and recommending alternative standards of currency and exchange. Owing to the disabilities under which this committee had to work, coupled with abnormality of the times, when the price of silver was rapidly rising every day; the Committee could not be expected to have made recommendations which might have given India a suitable standard of currency and exchange. Under those most abnormal circumstances the Committee endorsed the then existing gold currency exchange standard system, but at a ratio of 2s. gold instead of 1s. 4d. as previously. These recommendations were accepted by the Secretary of State and the new exchange value of the rupee was enforced.

It is very pertinent to note here that December 1919 was a time when the price of silver was very high i. e., 78d. per ounce and as such gold was very cheap in terms of silver. It was a very suitable time when India could adopt a gold currency or gold bullion standard by purchasing cheaper gold in the world markets in exchange of her silver whose value then had so much risen. Had India cared to make use of such an exceptionally suitable opportunity, India would have secured a gold currency or gold bullion standard at a very low cost. But very unfortunately the terms of reference of Babington Smith Committee were such that it could not recommend anything else, but a continuance of gold currency exchange standard for external purposes and a silver rupee and paper currency for internal circulation.

Soon after the publication of the Babington Smith Committee report, there grew up in India a keen demand

for remittances to London. Steps were taken to maintain the new external exchange value at 2s gold per rupee. Reverse Councils were sold by the Government of India without limit at rates 2s 3½d to 2s 4½d sterling. Thus a good deal of gold which had accumulated in the past in the Gold Standard Reserve Fund in London at rates of about 1s 4½d per rupee was given out at rates of approximately 2s gold per rupee. Sovereign was made legal tender at Rs 10. The attempt to maintain the external exchange value at 2s gold was not successful. Then the Government tried to maintain the external exchange value of the rupee at 2s sterling but that also failed and it went on continually falling. In September 1921 it came to the low level of 1s 3d sterling or 1s gold. Thus 2s gold exchange Standard recommended by the Babington Committee remained merely a nominal statutory rate. By January 1923 trade conditions changed and external exchange value of the rupee recovered to 1s 4d sterling and by October 1924 it came up to about 1s 6d sterling or 1s 4d gold. Further rise in the exchange rate was arrested by free purchases of sterling by the Government. Meanwhile sterling also came back to parity with gold in England which had gone off gold standard in 1920 came back to gold standard in July 1925. From July 1925 to June 1926 the external exchange value of the rupee improved from 1s 6d sterling to 1s 6d gold.

Gold Bullion Standard—In autumn 1925 was appointed the Hilton Young Currency Commission to examine and report on the Indian currency and exchange system and practice and to recommend whether any changes were desirable. It should be noted here that the terms of reference of this Commission were much wider and extensive than those of the Babington Smith Committee. This Commission examined the different alternative schemes of monetary standard and currency system of India—Gold Exchange Standard, Sterling or Gold Currency Exchange Standard and Gold Currency Gold Standard, but rejected all of them. Ultimately these Commissioners recommended Gold Bullion

Standard system for India. Their pertinent recommendations are given below:—

(1) For internal circulation silver rupee was to be the standard of currency, and rupees and notes were to remain in circulation. For internal purposes gold was not to circulate as money. Sovereigns and half-sovereigns were to be demonetised. Gold currency was not to circulate at first or ever.

(2) For external purposes silver rupee was to be linked to gold at a parity of 1s. 6d. per rupee and the currency authority in India was to be under statutory obligation to buy and sell gold bars without limit in quantities not less than 400 ounces (1065 Tolas), and with no limitation being imposed as to the purpose for which gold was required, according to the following arrangements:—

(a) To buy gold bars in India in exchange of notes and silver rupees without limit at the fixed rate of exchange *i.e.*, Rs. 21-3-10 per Tola (180 grains) of fine gold.

(b) To sell gold bars without limit for delivery in London at 1s. 6d. per rupee plus a charge covering the cost of shipment to London and loss of interest for the period that gold remained in transit from India to England. This provision was made to check the fall of the external exchange value of the rupee below the lower gold point in case of an adverse balance of trade

(c) To sell gold bars without limit for delivery in Bombay for monetary purposes in case of a favourable balance of trade at 1s. 6d., when the exchange value was at or above the upper gold point. This provision was made to allow a free flow of gold from England to India.

(d) To sell gold bars without limit for delivery in Bombay when the exchange rate was lower than the upper gold point at 1s. 6d. per rupee plus twice the shipping and interest charges. This provision was made to prohibit people from demanding gold bars for non-monetary purposes, for the price proposed to be charged was such that gold purchased

under that arrangement was to cost more than gold imported from England

In view of the above provisions the Commissioners asserted that as gold bars were to be given in exchange for notes or silver rupees, not for export only but for any purpose this was not an exchange standard but an absolute gold standard. It must be noted here that in their enthusiasm to emphasize the importance of their recommendation, the Commissioners called their scheme an absolute gold standard, though precisely speaking they really recommended a gold bullion standard

Sterling or Gold Currency Exchange Standard—After the Hilton Young Commission report was issued, the Currency Act 1927 was passed. The important provisions of this act were —

(1) Valuing of silver rupee at 847512 grains of gold instead of 1130016 grains of gold according to the Indian Paper Currency Act of 1923. Thus it fixed the exchange value of the rupee at 1s. 6d

(2) Demonetisation of sovereigns and half-sovereigns or the taking away of legal tender character of the sovereign and half sovereign, which under the Indian Paper Currency Act 1923 were made legal tender at the rate of Rs. 10 and Rs. 5 respectively.

(3) Statutory obligation to purchase gold and sell gold or sterling according to the following arrangements —

(a) to purchase gold bullion bars tendered by the public containing not less than 40 tolas of fine gold at the rate of Rs. 21/3/10 per tola : *i.e.*, at the rate of 1s. 6d. per rupee.

(b) to sell to any person who made a demand of gold for delivery at Bombay or Sterling for immediate delivery in London, whichever be convenient to the Currency Authority at the rate of Rs. 21/3/10 per tola of fine gold, provided that no person was entitled to demand an amount of gold or sterling of less value than that of 1065 tolas of fine gold ;

(c) for purpose of determining the equivalent rate applicable to the sale of sterling the Act stated that Rs. 21/3/10

were to be deemed equivalent to such sum in sterling as was required to purchase a tola of fine gold in London at the rate at which the Bank of England was bound by law to give sterling in exchange for gold, after deduction therefrom of an amount representing the normal cost per tola of transferring gold bullion in bulk from Bombay to London, including interest on its value during transit. This rate was to be determined by the Governor-General in Council from time to time and notified accordingly.

Thus we see that the Currency Act of 1927 did not uphold Gold Bullion Standard System recommended by the Hilton Young Commission of 1926, but merely provided a sterling or gold currency exchange standard with this addition, of course, that under the above Act the currency authority in India for the first time came under legal obligation to buy gold and sell gold or sterling whichever be convenient to it, at the maximum and minimum specie points, calculated at the basis of the fixed parity of 1s. 6d. Before this Act currency authority in India was statutorily bound to give rupees in exchange of sterling at the fixed parity plus cost of transport of gold from England to India, but there was no legal obligation on the part of the Indian Currency Authorities to give sterling in exchange of rupees at the fixed parity minus the amount representing the cost of transport of gold from India to England or the lower specie point. Under 1927 Act for the first time the currency authority in India came under statutory obligation to maintain the external value of the Indian Standard or rupee within the gold points determined according to a fixed parity of 1s. 6d. per rupee.

After the Currency Act of 1927 during the first $2\frac{1}{2}$ years i. e., ending with September 1929, there was a general improvement in economic conditions of the world and India. India's trade condition was also good and exchange in November 1929 was at the upper gold point. But after this date there began a general fall in prices and depression in trade and industry. In India though the monsoons and harvests were good, but owing to collapse in world prices and

depression in world trade India's export trade fell very heavily. The reaction of these factors on Indian exchange was inevitable. Exchange rate began to fall and the Government of India had considerable difficulties in remitting sterling to London to pay off the home charges. In order to tighten up money the Government issued continuously Treasury Bills of considerable amounts, and this enabled the Government to maintain the exchange value of the rupee without selling gold or sterling. But collapse in New York Stock Exchange boom further lawered down the prices of commodities and Government's difficulty in purchasing sterling increased. It had to pay very high discounts on Treasury Bills and the Imperial Bank Rate had to be raised. In spite of these the exchange continued to remain weak and in March 1930 it was 1s. 5½d. In order to meet home charges the Secretary of State had to float Sterling Bills and a Sterling Loan. This exchange weakness continued upto October 1930, when Civil Disobedience Movement was in full swing. By the end of March 1931 exchange gained strength and reached 1s 5½d.

During 1931-32 and 1932-33 there began a serious outflow of capital from India due chiefly to three causes :—

- “(1) the seasonal weakness of the demand for money ;
- (2) the more important tendency created by the political situation of the country to sell investments in India and take the proceeds out of the country ; and
- (3) the tendency on the part of cautious investors to spread their risk by investing part of their capital abroad.”¹ To prevent this outflow of capital Government had to issue continuously considerable amounts of Treasury Bills in order to withdraw funds from the market and make the money tight.

In May 1931 began a financial crisis. It took its origin in Austria. A large Austrian Bank namely Creditanstalt collapsed due to its heavy industrial investments. As a result of this the first neighbouring country exposed to the danger of panic and withdrawals of capital was Germany. To

1 History of Indian Currency and Exchange by Prof. B. E. Datta Chakraborty, page 201.

check panic, the Government of Austria was helped by the Bank of England and the Bank of International Settlements, and on 20th June 1931 the President of the United States announced one year's moratorium for the Great War reparation and debt payments. Huge credits were granted to the Reichsbank by the Bank for International Settlements and the Central Banking Institutions of U. S. A., England and France. Panic was great and it found its way even in England. England too experienced, for the first time in her history, a net balance of indebtedness against England amounting to £95 millions. England's credit balances in the countries of Central Europe had become frozen by the inability of these countries to meet their foreign obligations. Moreover when there was a panic in the countries of Central Europe, large amounts of foreign deposits had found their way in London, but when panic appeared in London itself, it put London at the mercy of those depositors who, if their confidence was shaken in any way, could withdraw their deposits. That was what exactly happened. France, Netherlands, Belgium, Switzerland and other countries started withdrawing their floating balances from London. Thus frozen assets on one side and a sudden run of depositors on the other put London suddenly in the position of a bank which had a run on it and that also of extraordinary proportions. Between Wednesday morning September 16th and Saturday mid-day September 19th 1931, over £43 million of short term funds were withdrawn.¹

The Bank of England made tremendous efforts to create confidence by shipping gold to the countries withdrawing the balances, but the withdrawals increased so rapidly that by September 20th, 1931, the gold holding of the Bank dropped to the low figure of £13 millions. On September 21st, therefore, legislation was passed suspending the Bank of England's obligation to give gold against its notes and England went off gold standard. Great Britain's action was followed by

1. History of Indian Currency and Exchange by Prof. B. E. Dadachanji, pages 204 E. & F.

similar actions practically in the whole of the British Empire with the exception of South Africa and Canada. By Ordinance No. VI of 1931 dated September 21st, the Government of India relieved themselves from their liability under the Currency Act of 1927 to sell gold or sterling, and the three days, 22nd to 24th September 1931 were declared public holidays.

Paper Sterling Exchange Standard—On September 24, 1931, the Government made another Ordinance No. VII. This cancelled the previous Ordinance No. VI and linked the rupee again to sterling at 1s. 6d. It also limited the sales of gold or sterling by the Government only to the Calcutta and Bombay branches of certain banks recognised by the Governor-General in Council and only for normal trade requirements and reasonable personal or domestic needs. The conditions that followed the above Ordinance however did not justify the enforcement of the above exchange restrictions and control, and as a consequence this second Ordinance No VII was repealed by a third Ordinance made on 30th January 1932. Thus by executive action the rupee was delinked from gold sterling and linked to paper sterling at the rate of 1s 6d., and is in practice since then fluctuating between 1s 5½d and 1s 6½d as regulated by the Government and by the Reserve Bank since April 1, 1935. It should be noted here that from September 1931 to July 1932, English currency remained an unmanaged paper standard. Consequently the Indian currency standard during that period was an unmanaged paper currency exchange standard. In July 1932 England, though off gold standard, brought her paper standard under a suitable management, and as such the Indian currency standard since then became a managed paper currency exchange standard.

Another point worth noting in this connection is the effect of Great Britain's suspension of gold standard and India's adoption of a managed paper currency exchange standard. The result of England's going off gold standard was that sterling became depreciated in terms of gold to the

extent of about 30 per cent. immediately and 40 per cent. later on. As soon as other gold standard countries of the world also suspended the gold standard, people became afraid of heavy depreciation of their holdings of paper currency and began to convert them into gold. In all such countries people began to hoard gold on a large scale. Consequently there was a great demand for gold in most of the countries and the price of gold began to increase. Some countries like France & U. S. A. adopted the policy of insisting on receiving payments of their war debts or reparations in gold and buying up gold from various countries and hoarding it in their central banks. All these factors accentuated the demand of gold all the more, and its price went on becoming higher and higher. The rapid rise in the price of gold in the world markets brought its influence on India as well. In this country also the price of gold began to rise to unprecedented heights.

A high premium on gold prices encouraged the people of this country, who had any quantity of hoarded yellow metal, to take advantage of that and sell off their holdings. This tendency of selling their gold holdings was accentuated all the more by the all round economic depression and heavy fall of agricultural prices. The fall of agricultural prices was not accompanied by a proportionate reduction in the expenses of agricultural production, and the result was that most of the agriculturists under acute distress parted with most of their gold holdings in order to meet their expenses. Bullion dealers all over the country collected huge quantities of gold from the interior towns and rural areas and exported that to foreign countries for that became a very profitable business.

Average Value of Imports and Exports at Gold Coin and Bullion for each Quinquennium from 1900-01 to 1924-25 and for each of the Financial years from 1925-26 to 1939-40 in crores of rupees —

Years	Imports	Exports	Net Imports +	Net Exports -
Average for				
1900-01 to 1904-05	15 07	8 83	+ 6 23	
1905-06 to 1909-10	17 49	5 75	+11 74	
1910-11 to 1914-15	29 92	4 57	+24 34	
1915-16 to 1919-20	19 64	6 23	+13 41	
1920-21 to 1924-25	36 45	7 74	+28 70	
1925-26	35 22	37	+34 85	
1926-27	19 50	10	+19 40	
1927-28	18 13	03	+18 10	
1928-29	21 21	02	+21 19	
1929-30	14 23	01	+14 22	
1930-31	13 24	49	+12 75	
1931-32	2 79	60 77		-57 97
1932-33	1 31	66 84		-65 52
1933-34	1 09	58 15		-57 05
1934-35	71	53 25		-52 53
1935-36	94	38 30		-37 35
1936-37	1 60	29 45		-27 64
1937-38	1 56	17 90		-16 33
1938-39	72	23 98		-23 26
1939-40	72	45 36		-44 64
Total for 31 years from 1900-01 to 1930-31	714 50	165 75	+547 75	
Total for 9 years from 1931-32 to 1939-40	11 51	394 03		-382 52

The above table shows that during a short period of about 9 years India exported gold worth Rs 382 52 crores which she had accumulated in a period of about 21½ years. Thus the total loss of India's capital or reserve power of purchasing in international markets since England went off

gold standard in September 1931, amounted to Rs. 382'52 crores or about 55 per cent. of its stock.

Present Monetary Standard—On April 1, 1935 the Reserve Bank of India came into existence and since then the business of maintaining the internal and external exchange value of the Indian rupee has been handed over to that Bank. Internally the currency standard is the same old silver rupee, but for maintaining its external exchange value, the Bank has under Sections 40 and 41 of the Reserve Bank of India Act 1934 been compelled to sell sterling at the rate of 1s. 5 $\frac{1}{2}$ d. per rupee and to buy sterling at the rate of 1s. 6 $\frac{3}{4}$ d. per rupee—the lower and upper limits between which the external exchange value of the rupee is allowed to fluctuate according to economic conditions of the country. Since the out-break of the present world war three important changes have been made in the Indian standard and currency system. Firstly in the present issue of Quarternary rupees the silver content has been reduced to 50 per cent. Secondly there is an issue of one rupee notes by the Government of India which are unlimited legal tender and are to be treated as silver rupees. Thirdly the paper notes issued by the Reserve Bank are not freely convertible into silver rupees. Thus internally India has a managed paper standard and externally its exchange value has been fixed in terms of managed paper sterling standard. Consequently the present Indian currency standard can be called a managed paper sterling exchange standard, and it is open to all possible manipulations and other defects which such an artificial standard can have.

Questions

1. Describe briefly the monetary standard in India before the coming of the British. What were its main defects?
2. What is silver standard? Trace the history of monetary standard in India from 1835 to 1893.
3. What were the main recommendations of the Herschell Currency Committee and how far had they been enforced by the Government of India?
4. Trace briefly the history of Indian monetary standard from 1893 to 1899.

5. What circumstances led to the appointment of Fowler Currency Committee of 1898 ?

6. What were the main recommendations of the Fowler Currency Committee with regard to monetary standard for India ? How far had they been accepted and enforced by the Government of India ? Describe.

7. What is gold currency exchange standard ? When and how did India adopt it ? Describe.

8. Compare gold currency exchange standard and gold exchange standard. Which of the two did India adopt in 1898 and how ?

9. What is gold bullion standard ? What were the main recommendations of the Hilton Young Currency Commission with regard to the introduction of this system in India ? Explain.

10. What monetary standard had been recommended for India by the Hilton Young Currency Commission ? What monetary standard had been adopted by the Government of India after the Commission's recommendations ? Explain the difference between the two

11. What were the main recommendations of the Chamberlain Currency Commission with regard to monetary standard for India ? Comment on those recommendations.

12. Trace the causes of the breakdown of the gold currency exchange standard in India during the Great War of 1914-18 and describe briefly the measures adopted by the Government of India to prevent a great rise of the external exchange value of the rupee.

13. Describe briefly the origin, functions and present position of the Indian Gold Exchange Standard Reserve.

14. What circumstances led to the giving up of gold exchange standard by India in 1931 ? What standard was adopted by India after that date ? Describe.

15. What is paper currency exchange standard ? When and how did India adopt it ?

16. What is the present monetary standard of India ? What are its main defects ? Suggest some suitable remedies.

17. Trace the history of Indian monetary standard from 1919 to 1931.

18. What were the main effects of India's adoption of paper sterling exchange standard in 1931 ? Describe fully.

19. What is the position of the present Indian rupee ? What monetary standard does it represent ? Suggest a suitable name for that standard.

20. Suggest a suitable monetary standard for India and give your complete arguments in its favour

CHAPTER VI

CHARACTERISTICS OF A GOOD MONETARY STANDARD

In the present day civilised life wants of men are many and varied and these multifarious wants are satisfied by a complex organisation based on division of labour and exchange of commodities and services. There was a time when people exchanged, what they had in surplus for what they wanted, directly or without the use of money or currency *i. e.*, commodity for commodity, and this system of exchange was called barter. Even today in some remote and backward parts of this country as well as other parts of the world people exchange their surplus commodities directly or under the barter system, but in most of the other places people do not barter but buy and sell commodities. The simple reason for this is that in many cases the barter system is very inconvenient.

The greatest inconvenience of barter system is the necessity of double coincidence of wants or the difficulty to find two persons whose disposable possessions mutually suit each other's wants. Moreover some commodities are more valuable than others and at the same time they are also not divisible. Consequently in the exchange of a less valuable commodity for a more valuable one, the difficulty that sometimes arises is the impossibility of dividing the more valuable commodity so that only a portion of suitable value may be given in exchange of the less valuable commodity. To avoid these inconveniences people carry on the business of exchanging their commodities through an interposed commodity called money or currency. Thus money or currency of a country means different units of a commodity with the help of which the people of that country mutually carry on the exchange operations of their surplus commodities.

People of different countries of the world at different times selected different commodities to help them in their exchange operations by acting as common media of exchange. Of all the commodities so selected ultimately people experienced

that gold and silver served their purposes much better than any other commodity. Thus in course of time these metals became the money materials of all the countries of the world and different pieces of these metals began to help in their exchange operations. The values of these metals depended upon their weight and purity. Hence people still had the difficulty of weighing and testing the purity of the different pieces of these metals before they could accept them in exchange of their commodities. To avoid these difficulties it became necessary to make different pieces of these metals of standard weights and purity. This led to a suitable system of coinage.

Coinage could not solely be left into the hands of the general public. Consequently it became necessary to have a centralised system of coinage under the control of the government. In this way coinage or the making of different units of money or currency became a function of the government of every country, and for this purpose mints were established. These mints made coins of gold and silver and issued them to the general public in exchange of gold and silver. In course of time it became necessary to help the petty exchange operations of the people by providing them coins of smaller values, and as they could not easily be made of such costly metals as gold and silver, they were made of other cheaper metals such as nickel, brass, copper, bronze, etc. Thus gold or silver coins of big values formed the standard money or chief currency and coins of other metals formed the subsidiary or supplementary currency.

In course of time both the people and currency authorities found that for circulation inside the country hundred per cent use of gold or silver coins was expensive, inconvenient and risky. Consequently there arose the necessity of having notes or paper currency, and in different countries along with the metallic currencies there developed also paper currency systems. In some countries paper currency is issued by the Government, while in most of the others it is done by the Central Banks. Thus at present in all the advanced countries of the world money or currency consists of paper currency

and metallic currency, and these two forms of money help the exchange operations of the people of those countries. Therefore money or currency of a country consists of its various metallic coins and paper notes issued by the Government or Central Bank or Banks of that country which circulate in their relationship to the standard money as established by law or practice in that country for the time being.

In every country there is a chief money unit called the standard money and plenty of other money units including paper notes of various denominations called the subsidiary or supplementary money. It should be noted here that in every country all other money units including paper notes gravitate round the standard money of the country for they bear fixed exchange relations with it. Thus all other money units are nothing but mere representatives of their country's standard, and the efficiency or otherwise of the money or currency system of a country depends almost entirely on the position of its standard. If the standard money of a country is good, then to a very large extent the entire currency system is good. On the other hand if the monetary standard of a country is not good or efficient, then the entire money system of that country is bad and inefficient. The monetary standard of a country in order to be good should possess the following important characteristics :—

Confidence—The economic life of the people of a country and with it their material and social welfare are intimately connected with her money or currency system. The different economic activities of a country such as trade, manufacture, agriculture, etc., can not work well unless the money or currency system of the country is able to perform its four important functions i.e., to act as a standard of value, medium of exchange, store of value and standard for deferred payments, with economy and efficiency. In order that the money or currency of a country be able to perform these functions well it is necessary in the first place that her people should have confidence in the value of money or currency standard of their country—the confidence that any form of money or

currency that they accept in exchange of the commodities that they sell shall enable them to obtain other commodities that they desire to have whenever and wherever they like to have them in that country. This means that the people of the country should have confidence that their money has and shall ever have the general power of purchasing other commodities at an exchange value. Further it is also necessary that their money shall always have a stable exchange value.

If the people of a country have no confidence that their money shall ever have an exchange value and that too at a stable rate they shall hesitate in accepting such a money or currency in exchange of their surplus commodities. Thus that money or currency shall not act as a good medium of exchange and trade and industry would be hampered. Consequently we see that confidence is an essential feature of the currency system of a country. For this confidence it is necessary that the intrinsic values of the different money units of a country should be equal to their face values or values at which they are put into circulation by the currency authorities. This is absolutely necessary in the case of at least that unit of money of a country which is made legal tender to an unlimited extent. Generally out of all metallic money units of a country it is the standard money which is made legal tender to an unlimited extent. Hence in order to have a good currency system it is necessary for a country that it should have a standard money whose face value is always equal to its intrinsic or bullion value. If it is so people have confidence in their standard money and the currency system of the country is able to perform all its functions suitably and well.

The Indian currency system is defective in this respect. In India rupee is the standard money of the country but its intrinsic value is much less than its face or fiduciary value and for purposes of making foreign payments its value is fixed at 1s 6d in terms of sterling which is off gold standard. Thus the fact that internally the fiduciary or official exchange

value of the Indian standard is much higher than its intrinsic value and externally its exchange value is 1s. 6d. of managed paper sterling is not intelligible to most of the people of the country. For these reasons the present Indian monetary standard and currency system do not command that confidence of the people of the country which is essential for their smooth and efficient working; and the sooner it is replaced by a better standard say gold bullion standard, it will be to the best economic interests of the country.

Efficiency—Money or currency is required by people to make purchases of other commodities. Generally purchases are made inside a country, but sometimes they are made from other countries of the world as well. Thus the currency system of a country should be such which may enable her people to make their internal and external purchases and sales cheaply and conveniently. This means that the standard money of the country should be such whose value remains more or less stable both inside the country as well as externally in terms of currencies of other countries of the world. For this reason it is necessary that as far as possible the standard moneys of the different countries of the world should be made of or be convertible into the same metal, so that if there be any change in the value of that metal it may affect all the countries equally whether it be towards a rise or a fall. If it is so people are able to make reasonable estimates of the prices at which they should make their purchases and sales and trade is not hampered.

On the other hand if a merchant does not know or is not able to gauge even the approximate cost which he will be required to pay for some goods which he wants to purchase from a foreign country and as such is not able to compare his proposed purchase price with the price at which he would be able to sell the same in his own country, he shall hesitate in making such foreign purchases. Similarly if owing to the instability of the external value of the standard money of his country a merchant is not able to estimate correctly what value he will get for his exports to a foreign country in terms of

currency of his own country and thus he is not able to compare accurately the real price at which he sells to a foreigner with that at which he can sell internally, he will hesitate in selling goods abroad. From these facts it is evident that trade and commerce of such a country would be hampered.

For the above reasons it is necessary that the currency standard of a country should be such that her people may be able to measure *approximately*, if not *exactly*, how much of their home currency they would be required to give or would receive in case they purchase or sell some commodities in terms of currency of another country. This is generally possible when the standard moneys of the two countries are made of or are convertible into the same metal and their official weights and fineness of metal are not frequently changed. If it is so they are able to maintain both their internal and external values at a firmer basis than otherwise is possible. Thus another important feature of a good currency standard and along with it the entire currency system is that the monetary standard of a country should be able to maintain its internal and external values at stable rates. To achieve this end and especially the latter it is necessary that a country should have its standard money of the same metal of which the standard moneys of other countries with which her people trade, are made or are convertible.

Consequently another important characteristic of a good currency standard and system of a country is the stability of the internal and external values of her standard money and through that the stability of prices of general commodities within the country and thereby promoting the smooth working of consumption, production and exchange, and a stable external value *i. e.*, stability of foreign exchanges with other countries and thereby maintaining and developing foreign trade. Thus briefly put the currency standard of a country should be efficient enough to perform its functions well, and to achieve this end in modern times when almost all the important countries of the world have adopted a gold bullion standard, that country should also as far as possible have its standard money of the same metal and only then it will work as an efficient standard and

maintain an efficient currency system. The present Indian standard is defective in this sense. During the past 40 years of the present century there have been very steep and frequent changes in the exchange value of the Indian standard both internally and externally and they have harmed Indian trade, commerce and industry from time to time. For this reason it would be better if the present Indian monetary standard be replaced by a gold bullion standard at the earliest possible opportunity so that it may work efficiently and serve the economic interests of the country best.

Economy—The third important characteristic of a good currency standard and system is its cheapness. The standard should be cheap in its introduction as well as in its maintenance after it has been introduced. That is, the standard and system should be economical both in the beginning and ultimately. Economy demands that the currency standard of a country should be according to the stage of economic development of that country. 'If a country is poor, its national dividend is small, per capita income of the people is small and the average value of transactions is small; the country should have a cheaper standard. Silver standard is more economical than gold. It can work well both internally and externally if most of the foreign trade of a country that has it, is with such other countries of the world which also have silver standards. If however the country is poor and most of her foreign trade is with gold standard countries, economy will demand that it should have a silver standard for internal purposes and a gold standard for her external payments which may be a gold exchange or gold currency exchange standard. But it must be noted here that gold exchange or gold currency exchange standards are artificial standards, and as such though as compared to gold currency or gold bullion standards they are cheap, yet they suffer from many other defects such as lack of confidence, lack of simplicity, inefficiency, etc.

If most of the foreign trade of a country is with gold standard countries and the country is sufficiently advanced in her economic activities, national dividend is high, average

a free coinage system, people have neither any great attraction for melting coins nor any person cares much to make counterfeit coins of standard weight and fineness. There is no doubt that even in a country of free coinage people have an attraction of making counterfeit coins which as compared to the standard coins of the country are either smaller in weight or inferior in fineness of metal, but it must be noted that detection of such counterfeit coins is much simpler than of coins that are counterfeit, but contain standard weight and fineness of metal. It is really very difficult to detect counterfeit coins of the latter type. Consequently the government of a country which has a free coinage system has not to undertake the tremendous trouble and expense of checking the melting of standard coins or the making of unauthorised ones. Thus countries where coinage is free and face values of the coins are equal to their intrinsic values, chances of melting or making counterfeit coins are the least.

Generally people have great attraction in making or melting standard coins rather than the subsidiary coins, for the fact that that coin is usually the coin of the greatest value and is legal tender to an unlimited extent. Consequently a currency standard and system in order to be good and simple in management should have a free coinage of its standard, but this is not possible unless the face value of the standard money be fixed at an amount equal to its intrinsic value. Monometallism with gold or silver standard in its strict, pure or direct sense is the most simple currency standard for a country and requires the least expense of management. On the other hand a gold exchange or gold currency exchange standard, bullion exchange standard, sterling exchange standard, or any other artificial standard is not simple enough in management. These standards or currency systems require a complex and expensive machinery for the maintenance of their external and internal values such as exchange standard reserve funds, and maintenance of a big band of government officials to prevent and detect cases of unauthorised making or melting of coins.

Further it should be noted that the currency standard of a country should be so simple that it may be understood by its people very easily and clearly. The people should know exactly what their money is and what are its internal and external values. The people should be able to know exactly how much of other things their money can purchase in their own country and in the other countries of the world. This is possible only when their money is such that its intrinsic value is equal to its face value, i. e., when they know that their money in exchange is worth what it contains intrinsically or what it can be sold for as metal in the market. This means that the currency system should be based on free coinage principle. On the other hand if there is no free coinage and the value of the standard money as legal tender is higher than its intrinsic or metallic value as is the case with the gold exchange standard, the bullion exchange standard or the sterling exchange standard, the people are not able to understand the exact internal and external values of their currency standard. These forms of standard money are not intelligible to millions of educated people and can not be so, unless through a constant propaganda people are acquainted with the exact nature of these standards. Thus a country where people are mostly illiterate these forms of standard money can not be easily and clearly understood by them. Consequently they would have no confidence in their currency and will always hesitate in accepting or storing it.

In India at present there is no free coinage. There is neither a gold standard nor a silver standard. For internal purposes India has a measure of values and a medium of exchange made of silver, whose intrinsic value is much less than its face value, while for her external requirements India has a sterling exchange standard, i. e., people are entitled to obtain in exchange of their rupee gold or sterling whichever be convenient for the Reserve Bank of India to give at the time of the demand being made at the rate of 1s. 5½d. per rupee. These forms of external and internal values of the rupee and the relation between them is not

intelligible to an average Indian. Consequently he has little confidence in the currency system and monetary standard of his country. This is a highly artificial system of currency and the value of the standard money depends more on the Government policy and its administrative convenience rather than pure economic causes. For these reasons the people of this country look upon the present standard and system with feelings of distrust and consider it as a very complex and artificial one rather than a simple and intelligible currency standard. Consequently the present currency standard of India is not able to perform its functions so well as it is the case in gold currency or gold bullion standard countries. It is therefore evident that the currency standard of a country in order to be good must be very simple so that the people may be able to understand it properly and may have no distrust or lack of confidence. In modern times when currency standards of most of the countries of the world are on a gold basis a gold currency standard, no doubt, will be the most simple system; but in order to have economy as well it is necessary that a country should adopt a gold bullion standard which is sufficiently economical and is far simpler than any other form of indirect gold standard such as gold exchange standard, gold currency exchange standard, sterling or dollar exchange standard, etc.

Questions

1. What are the important characteristics of a good currency standard? Describe them briefly.
 2. What are the important defects of the present Indian currency standard? Explain them briefly.
 3. Does the present Indian currency standard command sufficient confidence of the people of India? If not, why not? Suggest some suitable remedy.
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CHAPTER VII

PAPER MONEY

Money or currency is required primarily to act as a medium of exchange of other commodities and services of a country. When money or currency comes into existence people exchange their commodities and services mostly through the medium of that money or currency. Thus in every country at all times there is a great demand of money or currency to help the community to carry on their day to day exchange transactions. Consequently there is always a use of a large volume of money or currency in every country. Constant use or handling of metallic money causes a depreciation of precious metals from wear and tear and from destruction or loss of the coins. Moreover in making large payments or payments to distant places the use of metallic money is not convenient, safe or cheap. These reasons lead to the introduction of paper representatives of metallic currency commonly known as currency notes or only notes. Paper money or notes were invented long ago but they have come into prominence only during the present century. The earliest issue of notes or paper currency is attributed to the Chinese in the ninth century, though there is some reason to believe that it was in circulation even in ancient Assyria and Babylon. In India in modern times issue of paper currency or notes by Government was tried by Warren Hastings as early as 1780 but later on in the eighties of the 18th century they were issued by banks like the General Bank of India, Bengal Bank, etc.

Merits and Defects of Paper Money

Merits of Paper Money—Paper money or notes replace in every country a large part of metallic money. If money or currency of a country consists of only metallic coins, a very big quantity of precious metals in that country remains frozen or locked up in the form of coins. This quantity of precious metals or wealth of the country does not contribute to any production of wealth directly. We have seen before that

money or currency is not required for its own sake but to help the community to carry on her exchange transactions. This work of money can be performed very well whether money is made of precious metals or of paper. Thus if a country has got enough metallic money for all its wants, and then a portion of its metallic money be replaced by introduction of paper currency or notes, the country would be benefitted in this way that the precious metals so released shall be available for investment in domestic arts and industries or to be used for purchasing commodities from abroad. Therefore the use of notes or paper currency in a country increases the quantity of directly usable wealth of that country and benefits all her people.

The use of precious metals like gold and silver in making metallic currency in different countries of the world necessitates the production of a huge quantity of these metals every year. There is no doubt that a big quantity of these precious metals is required every year also for purposes of arts and industry, but their use as money materials is much more important. Consequently a large quantity of labour and capital of the world remains constantly busy in the production of these metals. If all countries of the world give up the use of metallic money or replace major portion of it by paper currency, the demand of these metals shall become less and the labour and capital, which are now used for mining these precious metals for monetary purposes, shall be released and become available for other productive objects. Adam Smith^{w.} explains this advantage of the use of paper money in the following way. [Gold and silver money which circulates in any country may be properly compared to a highway, which carries to the market all the grass and corn of the country, but produces itself not a single pile of either. The judicious operations of banking in substituting paper money in place of a great part of gold and silver is a sort of waggon-way through the air; which enables the country to convert a great part of its highway into good pastures and corn-fields and thereby to increase, very considerably, the annual produce of its land and labour.]

When precious metals are used as money or means of exchange, there is a great loss through their wear and tear. There would be a great saving in this respect if paper notes are used as a means of making exchanges in place of metallic coins. Moreover paper money is more convenient, cheap and safe in making large and distant payments. Payment by notes needs less counting and testing of money than by coins. In case notes are lost in transit while their numbers are held by their owners that causes no loss to them for with the help of those numbers they can recover the amount from the currency department. Further the issue of paper currency in a country is of great advantage to its government for in times of emergency it can borrow from the paper currency reserve at a much lower cost than the rate of interest it is required to pay on raising funds by ordinary loans. Another great advantage of the use of paper currency to a country is that through its expansion and contraction in circulation the country can always adjust its total volume or quantity of money according to the requirements of trade and industry which differ at different times. This characteristic of money of a country is known as its elasticity and through the use of paper currency it is possible to have it in an ideal manner, while with the use of metallic money alone it is difficult to have a proper elasticity of the country's currency.

Defects of Paper Money—Paper money or notes of a country derive their value from the law of the country. The value of notes depends upon the confidence that their holders will get back in exchange metallic money or other commodities at the same rate at which they originally parted them. This is dependent upon the will of the government or the solvency of the issuing authority. If the law of the country demonstises its paper money or repudiates it, the holders of notes have in their possession nothing but worthless pieces of paper, for when notes have lost their legal recognition they have lost all. Instances of such a demonetisation or repudiation of paper money or notes are not wanting in the history of paper currency of different countries of the

world. Most prominent recent examples of such a demonetisation or repudiation of paper currency are the German Mark Notes and Russian Rouble Notes during and after the Great War of 1914-18. For these reasons the value of paper money is very precarious and its circulation is limited to a very narrow area generally a territory under the same government. Paper money has no intrinsic value and circulates in a country owing to its legal backing. Thus paper money is only national money, while metallic money is an international money for it always possesses an intrinsic value.

Another defect of paper currency is that if its total issue is not properly regulated its value highly fluctuates. Value of paper money or notes depends upon its total issue or quantity which sometimes is affected by the caprice or the policy of a government and not regulated according to the economic requirements of the country. So it is often issued in excessive quantities and the result is a heavy fall in its value with its attendant evils namely the loss of its purchasing power or a sharp rise of prices. This defect of an excessive issue of paper currency is very evident at present in India, where the general price level has increased by about three hundred and fifty per cent. and is causing a great distress to the different classes of people. This excessive addition in the quantity of money of a country is not possible through metallic money owing to its heavy cost, and therefore, the value of metallic money does not fluctuate so much as that of paper money. Paper money is best money under ideal conditions of regulation of issue, but it is the worst kind of money if it is enormously over-issued and becomes heavily depreciated.

Kinds of Paper Money

It has been stated before that paper currency or notes are representatives of a certain quantity of metallic money or precious metals. Generally a note stands for a certain number of units of standard money or standard coins of a country, and for this there is a backing of law because usually all kinds of paper money are made full legal tender. Notes

derive their value not from the paper on which they are printed, but from the law which gives them the privilege to represent a certain quantity of metallic money whether supported at their back by a reserve of an equivalent amount of metallic money deposited in the strong-room of the issuing institution or not. Some issue of paper currency may be backed by a hundred per cent. reserve of metallic currency or precious metal, while another may not be supported by any metallic reserve at all, or the reserve may partly consist of metallic money and partly of paper securities. Thus from the point of view of this backing of metallic reserve issue of paper currency may be divided into three kinds. The first is known as *representative paper money*, the second as *fiat paper money* and the third as *fiduciary paper money*. A fourth system of issue of paper currency is known as *fixed maximum note-issue system*. In this system there is no relationship between the amount of notes in circulation and the amount or percentage of metallic reserve behind that issue to support it.

1. *Representative Paper Money*—This represents a hundred per cent. amount of metallic money or bullion deposited in the safes of the issuing institution. These notes or certificates are mere receipts showing that an equivalent amount of precious metal is kept in the paper currency issuing institution and can be taken back from there on demand whenever the holders of the notes may choose to do that. Thus these notes are hundred per cent. convertible into metallic money or precious metal whichever they represent. The American Gold and Silver Certificates supported by gold and silver deposits in the Treasury of the United States and Gold Bullion Certificates recommended by the Hilton Young Currency Commission for India in 1925 are good examples of this kind of paper-money.

Representative paper money is supported by a hundred per cent. metallic reserve. Consequently it commands absolute confidence of the people and acts as a good form of money. A great advantage of this money is that to the extent it replaces metallic money, it saves it from depreciation owing

to wear and tear in use, but this system is not very economical from national point of view for the displaced metallic currency is kept in the paper currency reserve and not invested in any productive channel.

2. *Fiat Paper Money*—It consists of notes of various denominations representing various amounts of standard money of a country. In form they are like promissory notes, but their holders have no right to demand their equivalent amount of metallic currency. They are not at all supported by any amount of metallic reserve. Consequently they represent nothing and confer a claim to nothing, but represent in circulation a certain quantity of metallic money, because of the backing of currency law of the country which makes them legal tender. They derive their value not from any backing of metallic money, but from the fiat of government or of a bank authorised and backed by government of a country. Generally they are pushed into circulation when the government is hard-pressed for money. The most important examples of such money are the Greenbacks issued by the American Government during the Civil War, the French Assignats issued by the Revolutionary Government of France in 1789, and the Bank of England notes issued during the Napoleonic Wars. The Re. 1 notes issued by the Government of India during the present world war belong to this category.

If fiat money is issued in a country with careful control and limitation, it performs services of a good money sufficiently, and at the same time enables the government of the country to obtain plenty of funds without any or at the most a little cost. From national point of view this form of currency is very economical, but as generally there is not a suitable regulation over its issue and the result is its over-issue, it frequently circulates at a considerable discount and is unpopular. In times of emergency like war or any other national calamity this system of issuing paper currency is often resorted to by the governments of various countries to obtain gratuitous funds; but it is a very bad device of doing

that for it creates a feeling of distrust among the people towards their money and government.

3. *Fiduciary Paper Money*—This form of paper money consists of promissory notes wherein the issuing institution undertakes to pay to the bearer on demand the amount of metallic money represented by the denomination of the note. To be able to pay the value of notes or convert them in metallic currency, the issuing institution maintains a reserve of precious metal or metallic money. If the notes put in circulation command sufficient confidence of the public, the issuing institution knows that ordinarily all the notes put into circulation would never be presented to it for conversion. As such the issuing institution, whether government or central bank of a country, does not maintain the entire reserve in the form of precious metal or metallic money. A portion of the total value of notes issued is kept in the form of precious metal or metallic money, and the other is invested in interest bearing securities. In some countries this invested portion is legally fixed at a certain percentage of total issue. The invested portion of the paper currency reserve is technically called the fiduciary portion of the reserve and the other is called the cash or metallic portion of the reserve. In some countries the maximum of this invested or fiduciary portion of the reserve is fixed at a certain amount and whatever is the total value of notes issued the fiduciary portion remains fixed and does not fluctuate with the increasing amounts of paper currency in circulation. This is technically called the *Fixed Fiduciary System* of note issue. On the other hand if in any country the maximum amount of the fiduciary portion of the paper currency reserve is not fixed at a certain figure, but is fixed at a certain percentage of the total issue : *e.*, its amount increases with every increase in the amount of notes in circulation and decreases with every fall in the amount of notes in circulation, then that system is technically said to be the *Proportional Reserve System* of note issue.

3A. *Fixed Fiduciary System*—In this system as the maximum amount of the fiduciary portion of the paper currency

reserve is fixed at a certain figure, more importance is given to the convertibility or redemption of notes into metallic money. Consequently the principle on which this paper currency system is said to be based is called the *Currency Principle of Note-issue*. This system was adopted by England under the Bank Charter Act 1844 and still prevails in Great Britain, Norway and Japan. By this Act the Bank of England is authorised to issue its notes against authorised securities of an amount fixed by statute. In 1844 this amount was £14 millions and by September 1931 this had been raised to £275 millions. Any additional notes over and above this fixed fiduciary limit are secured by a gold backing of 100 per cent. In India this system worked from 1861 to 1920, with increases in the fixed fiduciary portion of the reserve from time to time as occasions demanded.

This system rests on the thoroughly sound doctrine that there is a minimum of currency which must always remain in circulation in the country unless the mechanism of exchange is to break down completely, and that so long as the fiduciary issue is well within that minimum, there is no danger of notes circulating at any discount or the purchasing power of paper currency being adversely affected. Under this system expansion and contraction of notes in circulation beyond the fixed fiduciary limit takes place at a rate exactly corresponding to the increase or decrease of the metallic reserve.

This system is very cautious and safe but incapable of expanding and contracting paper currency in circulation according to the changing economic requirements of a country from time to time. The system can work well only in countries where use of cheques is sufficiently developed and demands of additional currency or medium of exchange at different times are met by a larger use of cheques, or in countries where demands of currency from time to time do not vary much. The system can not at all work efficiently in agricultural countries like India where demands of currency vary enormously from season to season, and for this reason in 1920 it was replaced by the comparatively better propor-

tional reserve system ; though in England, Norway and Japan the fixed fiduciary system is continuing even today.

3B Proportional Reserve System—This system of issuing paper currency is in operation in many countries on the continent of Europe, in the United States under the Federal Reserve System in South Africa and in India. Under it the notes in active circulation are secured by a minimum percentage of gold or gold securities, which is laid down by statute, and which is 40 per cent in the case of U S. A., India and South Africa, and is less in certain other countries. These minima are not rigidly fixed and may be transgressed with the consent of the Government for short periods, on the condition that the issuing bank pays a tax reckoned on the amount of the deficiency. This tax is made to rise steeply as the deficiency increases. A steeply rising tax forces the issuing bank to take prompt measures to redress the situation by an appropriate credit policy and make up the deficiency in the metallic reserve.

The chief characteristic of this system is that under it expansion and contraction of paper currency do not (as in the case of the fixed fiduciary issue) take place at the same rate as the gold reserves increase or decrease but that it permits expansion and forces contraction in the proportion of 100-40. An addition of 40 units to the gold or metallic portion of paper currency reserve permits the issuing bank to issue notes of the amount of 100 units. Conversely a loss of metallic reserve of 40 units forces a contraction of notes to the extent of 100 units. The system thus permits a far wider range of expansion and contraction of paper currency or possesses the quality of elasticity to a far greater extent than the fixed fiduciary system. Consequently this system of issuing paper currency in a country is said to be based on the *Banking Principle of Note issue*.

Countries where the chief medium of exchange is legal tender money and not the cheque currency and where the demand of currency at different periods of time is widely different such as India, the system of paper currency most

suitable and which would permit the highest extent of required expansion and contraction of paper currency or elasticity without any great danger of over-issue is the proportional reserve system than the fixed fiduciary or any other system of issue. Theoretically India adopted the proportional reserve system of issuing paper currency under the Paper Currency Act XLV of 1920, but practically only since the establishment of the Reserve Bank of India on April 1, 1935 the system has come into full play.

4 *Fixed Maximum Note-issue System*—One more system of note issue, not commonly found now, is the fixed maximum note issue system. It prevailed in France as late as 1928. According to this system the law fixes a maximum limit beyond which notes cannot be issued no matter whatever may be the condition of paper currency reserve or the requirement of currency in the country. In this system there is no relationship between the paper currency in circulation and the paper currency reserve. Generally in this system the limit upto which notes can be issued is fixed keeping in view country's maximum requirement of paper currency in normal times. Consequently in periods of emergency this limit is bound to be revised and this needs fresh legislation from time to time.

There is no doubt that if the maximum limit is constantly regulated by law according to the varying economic needs of the country and the total issue at no time is excessive or short, the system is the best and works very well. But generally what happens is that at a time when the government of a country, which has this system is hard-pressed for funds, the fixed maximum limit is raised and notes are put into circulation much above the reasonable limit without backing of metallic reserve. The result is that there is over-issue, loss of confidence and fall of the purchasing power of money or a great rise of general prices with all their attendant evils.

Question

1. What do you understand from notes or paper money and what are the advantages of its use in a country? Describe briefly.

- ✓ 2 'Paper currency increases the wealth of a country'. Comment on the statement
- 3 What are the main characteristics of paper money? In what respect is it better than metallic money? Describe briefly.
- 4 What are the main defects of paper money? Explain them briefly
- 5 Paper money is both the best and the worst money. Comment on the truth of this statement
- 6 What are the different kinds of paper money from the point of view of convertibility or backing of metallic reserve? Describe them briefly
- 7 Compare the Representative and Fiat systems of issue of paper money and explain their advantages and disadvantages
8. What is Proportional Reserve System of issue of paper currency? How does it differ from the Fixed Fiduciary System? Explain the difference clearly
- 9 What is Banking Principle of note issue? Explain the system clearly with reference to Indian paper currency
- 10 Distinguish between the Currency and Banking principles of note issue. Illustrate your answer by means of examples of history of paper currency in India.

CHAPTER VIII

STATE VERSUS BANK ISSUE

From the time paper money has begun to be used as a medium of exchange in the different countries of the world, there have been two agencies of its issue. In some countries paper money was issued directly by the government, while in others it was issued by a bank or banks. In India before 1861 paper money or notes were issued by banks but from that date upto March 31, 1935 they were issued by the Government of India. From April 1, 1935 paper money in India has again begun to be issued by a bank called the Reserve Bank of India. In the past for some time there was a great controversy with regard to the right agency of issue of paper currency, but when the International Financial Conference met in Brussels in 1920 one of the resolutions passed by it was that "in countries where there is no Central Bank of

Issue one should be established," and in the years that came after the advice of Brussels Conference was widely followed.

Government issue of paper currency makes claims to certain advantages. Firstly it is asserted that as government enjoys greater credit, its notes command more confidence than bank notes. There is no doubt that in normal times government notes are more popular, but in periods of financial embarrassment due to war or any other national calamity, government credit goes to a low ebb and her notes do not command enough confidence. On the other hand if sound management of paper currency department of issuing bank or banks is assured by suitable legislation and effective government control and redemption of notes is guaranteed by the government, the bank notes are likely to be popular at all times.

Another advantage claimed by government issue of notes is that as government has a big organisation at its command and a direct power of legislation, it is able to study and gauge the currency requirements of the community from time to time more accurately and expand or contract more quickly the volume of currency according to trade activity or other economic requirements of the country. This argument is extremely fallacious. It is a well known fact that government machinery is very slow and stereotyped and in a period of emergent requirement of expansion or contraction of currency, the time taken by the government to affect the desired change may be too long and the emergency may be over before the necessary action is taken. Moreover the direct power of legislation and currency management involves the danger that at a certain time true economic interests of the community may be sacrificed by political considerations and financial needs of the government of that time, and the result may be that paper currency may be over-issued and mismanaged. A party in power in the government of a country at a certain time may influence the coming legislation or its enforcement for its selfish ends, which may be prejudicial to the interests of the community as a whole. On the contrary a bank issuing paper

currency has less chances of being influenced by any party politics, or its policy of working being deflected by budgetary deficits, wars or other national calamities. The amount of notes issued by it and the size and form of constituents which compose its paper currency reserve are regulated by specific laws and any departure from these is forced to be set right by the public opinion and government control.

Further the argument that with its huge organisation and a band of competent officials, the government of a country is able to judge the currency requirements of a country more accurately also falls flat when considered seriously and logically. The government of a country is primarily concerned with its administration and has rare opportunities of coming into closer touch with the trading community of the country and finding out its needs. It is a fact that even the best informed government can not know quickly and accurately when and where more money is needed or when and where from redundant currency is to be withdrawn. It is out of direct touch with the trade and industry, and consequently it is possible that at times the volume of currency in circulation may be much less than its demand and there may be a stringency of money in the country, or that the supply of money may be much in excess of its demand and there may be an overissue or inflation. Both of these state of affairs are harmful to a country.

Bank issue of paper currency is free from all the above defects. There is no doubt that the bank of issue has no power of direct legislation or possesses as big an organisation for studying the currency requirements of the country, yet it is certain that owing to its closer touch with trade, industry and finance of the country, the bank has far wider and better opportunities of judging more quickly and accurately the requirements of currency in circulation. Moreover if the powers already given to the bank of issue under currency legislation are sufficiently wide and elastic as is the case with proportional reserve system, the bank is able to affect the desired change or expansion and contraction of paper

currency more quickly than the state. It is an open secret that in a case of emergency private enterprise is more prompt in taking the desired or necessary action than the government of a country. Moreover the bank of issue by acting as a bankers' bank or central bank of the country has far more opportunities of estimating quickly and accurately the currency requirements of the country than the state.

When paper money is issued and used in a country, then out of the paper currency reserve some portion of metallic money is invested. This invested or fiduciary portion of the reserve brings a huge profit to the issuing institution. It should be noted that this profit is really the result of the entire community's consent to use paper notes in place of metallic currency. Consequently it is argued that the benefit of this profit should go to the entire community rather than a few hundred share-holders of the bank which issues paper currency. Very often this is given as an argument in favour of state issue of paper currency for the profit so earned by the paper currency department of the government can be added to its general revenues and to that extent either the taxation of the community can be reduced or expenditure for the welfare of the society can be enhanced. There is no doubt that there appears to be some force in this argument, but by a proper control of the bank of issue by government the above objective can be secured, i.e., the profit earned by the use of paper currency can be obtained for the benefit of the entire community rather than only the share-holders of the issuing bank. For this generally the rate at which dividend can be distributed to the share-holders of the issuing bank is fixed by law and the remaining portion of the profit of the bank is taken away by the state.

to the Government of India's funds out of its surplus profits has been Rs 1 33 crores¹. In view of the preceding arguments it is obvious that bank issue of paper currency is far superior a system than the government or state issue, and at present in almost all the countries of the world paper currency or notes are issued by a bank which is also a bankers' bank and a banker to the government of the country.

Single versus Multiple Issue

In the previous pages we have studied whether paper currency in a country should be issued by its government or some bank or banks and have come to the conclusion that bank issue of paper currency is superior to state or government issue. Now the question arises whether this privilege of issuing paper currency should be granted to only one bank or to all or several banks of a country. If notes are issued by only one bank in any country, the system of paper currency is known as the *Single Note Issue System*. On the other hand if notes are issued by all or several banks of a country, the system is known as the *Multiple Note Issue System*.

For a long time in many countries of the world notes were issued by several banks. In England before 1708 notes were issued by several banks. In that year an Act was passed forbidding all other joint stock banks except the Bank of England to issue notes but the private bankers still issued notes. By 1780 even the private bankers gave up the note issue business and since that date it became the exclusive monopoly of the Bank of England. In India also before 1861 notes were issued by several banks including the three Presidency Banks namely the Bank of Bengal, the Bank of Bombay and the Bank of Madras. From 1861 it became the monopoly of the Government of India but from April 1, 1935 under Section 22 of the Reserve Bank Act 1934 it has become the sole monopoly of the Reserve Bank of India.

Single issue system of paper currency by one bank

1. During the present war owing to huge profits Reserve Banks dividends to its share holders and its contributions to the Government of India have increased.

preferably the Central Bank of a country is regarded as better than by all or several banks of the country. Issue of paper currency is supported by a backing of metallic reserve. In case in a country paper currency is issued by all or several banks, the metallic reserve becomes divided and scattered. On the other hand if notes or paper currency is issued by only one bank preferably the Central Bank, the metallic reserves of the country remain concentrated or centralised. This is more economical and in times of grave national emergency the centralised reserve can be mobilised more easily to meet the situation.

Issue of paper currency and investment of a part or fiduciary portion of the paper currency reserve brings a profit to the issuing institution. Thus larger is the issue of paper currency and bigger is the investment of its reserves, greater is the profit of the issuing institution. In multiple issue system or the issue of paper currency by several banks there is the danger of over-issue, for all of them may try to issue more of their paper currency so that they may be able to invest more and earn bigger profits. Moreover competition among banks to increase their profit from this source may also result in reducing their metallic reserves to such a minimum which may endanger the convertibility of their notes. Further if notes are issued by several banks and their policies of issue and backing of metallic reserves differ, it is possible that notes of some bank or banks may be preferred in circulation as compared to those of others. Consequently there may be several sets of paper money or notes in circulation whose fiduciary values may be the same though their real values may differ.

If paper currency or notes are issued in a country by only the Central Bank of the country, not only the metallic reserves of paper currency remain concentrated and centralised, but there is also less danger of over-issue or beyond the legitimate trade requirements of the country, and there are greater chances of issue of paper currency being managed more with a view of insuring national economic

welfare rather than earning big profits and distributing heavy dividends to banks' share-holders. Moreover when paper currency is issued by only one bank, it is easier for the government of the country to control it, rather than when it is issued by many banks. Consequently under single issue system there is a chance of a better regulation of issue of paper currency than under multiple issue system. In view of the aforesaid arguments it is clear that single issue system by the Central Bank of a country is a better system than the multiple issue system, and as such at present in most of the countries of the world e g, England, France, Germany, India, etc the system followed is the single issue system. Even countries like U. S. A., Japan, etc. follow a substitute of the single issue system.

Elasticity and Mobility

Elasticity—Money is required to act as a medium of exchange of other commodities and services of a country. When money or currency comes into existence people exchange their commodities mostly through the medium of that money or currency. Thus money or currency is demanded by the people mostly to help them to exchange their surplus commodities, and in almost all the countries of the world this demand of currency is different at different times. If in any year a country has produced more of other commodities than in any other year, the people require more of currency to help them in exchanging their increased production. Even in the same year in every country and specially in agricultural countries the total quantities of commodities that are available for purposes of exchange are different in different seasons of the year e g, in India in the months of March, April and May when the crops are harvested there are huge quantities of agricultural commodities available for sale, while in the months of June, July, August and September the quantities of commodities available for sale are much smaller. Thus in India in the months of March, April and May there is a great demand of money or currency; while in the months of June, July, August and September this demand is greatly reduced.

For these reasons in order to work well the currency should be one which is capable of expansion when there is a greater demand for it, and it should contract when the demand of currency has fallen. In case it is possible for the currency system of a country to expand and contract its volume in circulation according to fluctuations in its demand due to brisk or dull trade, it works well and efficiently. This attribute of expansion and contraction of the currency system of a country according to its requirements at each time is said to be its *Elasticity*.

If the volume of currency of a country expands and contracts according to rise and fall of its demand *i.e.*, if the currency system is elastic, the bank rate and the value of money or the general level of prices remain more or less the same at different seasons of the year. Consequently the traders, producers, consumers and other persons do not suffer either on account of stringency of currency in the market or for the existence of an idle surplus of it. The different economic activities work smoothly and do not suffer for want of elasticity. On the other hand if the currency system of a country is inelastic, there are great fluctuations in the value of money or currency of the country at different times, and people suffer either for want of currency or for the existence of redundant currency. If the currency system is inelastic and as such the general price level fluctuates very widely, in times of stringency of currency and high bank rates producers are compelled to dispose off their produce at unreasonably low prices, while in times of idle money consumers are compelled to purchase the same at unreasonably high prices. Consequently both the producers and consumers suffer and the advantage is derived by only one class of men *i.e.*, the financiers or the capitalists, who gain at the cost of both the producers as well as the consumers. This means that inelasticity of currency system of a country helps the rich to become richer and compels the poor to become poorer. Trade and production are discouraged and the country cannot develop commercially and industrially. In no country trade and industry can

flourish well and permanently, if the value of money or general price level fluctuates at great heights within short intervals of time

For elasticity it is necessary that the currency system of a country should consist of not only metallic money, but that it should also have a well organised paper currency. If the currency of a country consists of only metallic money its quantity is more or less rigidly fixed, and it is really difficult to expand or contract its volume according to the rise or fall of demand of currency. On the other hand if a country has a reasonable quantity of good metallic currency and an efficient machinery for issuing paper currency, it is possible to increase the volume of total currency in circulation by issuing more paper currency at a time when its demand is great, and contract the volume of money in circulation by withdrawing surplus paper currency, when demand of currency has actually fallen

In order that the currency system of a country be elastic not only it is necessary that the system should consist of partly metallic money and partly paper currency, but also that those who have the authority of issuing paper currency should be in close touch with the commercial and industrial class of men of the country, so that they may be able to gauge their currency or credit demands correctly and quickly and be able to issue paper currency against their genuine productive demands represented by their trade bills and promissory notes. Generally these class of men are in closer touch with the banks of a country rather than its government. Hence for the currency system of a country to be elastic it is necessary that the issue of paper currency be done by its Central Bank and with that all other banks of the country should be closely connected.

In India upto March 1935 paper currency was issued by the Government of India and as it could not come in close touch with the credit requirements of the commercial class of persons or take up the business of money lending by discounting bills or other commercial papers generally offered by

these men, the paper currency and with it the entire currency system was extremely inelastic. Even the provision of emergency loan of Rs. 12 crores from the Government Currency Department to the Imperial Bank of India could not make the system sufficiently elastic. With the establishment of the Reserve Bank of India from April 1, 1935 and the transfer of authority of issuing paper currency from the Government to this Bank, the Indian currency system has become more elastic to the great advantage of the commercial and industrial development of the country. Further, for the paper currency system of a country to be sufficiently elastic not only it is necessary that paper currency be issued by its Central Bank, which is in touch with the money market and credit requirements of the country; but that the principle of issuing paper currency should also have a suitable provision for elasticity *i.e.*, the system should be the Proportional Reserve System of issuing fiduciary paper currency with a reasonable percentage of minimum metallic reserve.

The metallic currency system of a country should also be elastic. The system should be such that the authorities which issue metallic currency (generally the government of the country) should have no difficulty in increasing its volume by making more coins and issuing them, when really more of them are demanded. This is possible only when the standard money of the country is put in circulation by the government at a value either higher than or at least equal to its intrinsic value. But if the currency system adopted is such that there are possibilities of the intrinsic value of the standard money ever becoming larger than its face value, it would be difficult for the government or the currency authority to issue or put in circulation more coins at a lower value by making them at a higher cost. This state of affairs is possible when the standard money is made of silver or some other metal and its exchange value is fixed in terms of gold at a certain rate, *i.e.*, gold, bullion or gold currency exchange standard.

In the above metallic currency systems it is possible that at any time the market price of silver may become so

high that the market value of the silver contents of the standard money may become higher than its legal tender value in circulation. At such a time there will be a strong temptation to the people of the country either to hoard the silver coins or to melt them and use them as bullion rather than as currency, while the currency authority shall have great difficulty in making the silver standard money at a higher gold cost and putting it in circulation at a lower gold value. Consequently there are possibilities of having a great stringency of metallic currency in the country and with it of the entire currency.

In 1920 the market price of silver became so high that the intrinsic value of the Indian rupee became higher than its face value and there was a great stringency of metallic currency in the country. This was possible because India then had a gold currency exchange standard. During the present war as well due to a great rise of the price of silver there is a great stringency of metallic currency in India, but the shortage of metallic money at present has been more than compensated by an over-issue of paper currency. In order to avoid even the remotest possibilities of the risk of the above type, the silver contents of the standard money should be of very low gold value, but in that there is the danger of the public having little confidence in such a standard money.

Mobility—For the money or currency of a country to work as an efficient medium of exchange of the commodities and services of the country, not only it is necessary that its quantity or volume should be adjustable to suit the fluctuating requirements of its trade and industry from time to time, but also that it should be capable of being transferred very quickly and cheaply from one part of the country to another, or from places where it is at that time surplus to those where it is urgently needed. This capacity of money or currency of a country is known as its *Mobility*. The different countries of the world particularly countries big in area have different centres of trade and production scattered at distances far from each other, and activities of trade or industry differ at different

centres in different seasons of the year. For example in India in the months of June, July and August and again in the months of October, November and December lot of money or currency is needed in the rural areas by the cultivators to buy seed and manure and pay other expenses of cultivation like ploughing, levelling, hoeing, transplantation, weeding, irrigation, drainage etc., while in the months of September and October and again in March, April and May plenty of money is needed in the various inland trade centres and the port towns to buy the harvested agricultural produce. Not only this, even in the growing and harvesting of agricultural crops there is a difference of some time from place to place in the country. Then in the months of huge import of foreign goods at the port towns, there is a great demand of currency at those centres. Even the working of some industries like sugar etc., which are localised only in certain parts of the country is seasonal and consequently their demand of credit or currency differs from time to time. Thus it is obvious that demand of money or currency in different parts of a country fluctuates from time to time.

In view of the preceding facts it is evident that money or currency of a country, in order to work well and efficiently, should be capable of being shifted or transferred from one centre to another very quickly and cheaply or that it should be very mobile. For money or currency of a country to be mobile it is necessary that an adequate portion of it should consist of paper money, for as compared to metallic money, notes or paper currency is much more mobile. Secondly the system and agency of issue of paper money should be such that money or notes may be capable of being transferred from one place to another quickly and cheaply. For this it is necessary that as many notes of various denominations as possible should be universalised and that either the Central Bank of the country issuing paper currency should have its own branches at various important centres for the issue and return of paper money or that it should be in close touch with the various banks and other credit agencies of the country and should be acting as their bank or bankers' bank

excessive or scarce existence of money in circulation due to over or under-issue of paper currency or notes. The term *Reflation* also is intimately connected with inflation and deflation and precisely speaking applies to a policy of expansion or increasing the volume of paper currency in order to correct the mistake of deflation, if per chance it had been carried too far and thereby it discouraged trade and industry due to an extremely low level of general prices. Thus the terms inflation, deflation and reflation refer to the volume of paper currency in circulation in any country at any time as compared to its demand and respectively denote a state of its over issue, under-issue and a remedial process of change from an under-issue to a reasonable quantity.

Inflation, deflation and reflation are brought about by the Bank of Issue of a country through manipulation of its credit or discount policy as represented by its discount or Bank Rate. If the bank issuing paper currency in a country is a bankers' bank (which is generally the case) all other banks of the country are intimately connected with it i.e., whenever they have any surplus money they deposit it in the Central Bank, and whenever they require more funds they rediscount at the Central Bank the traders' bills and promissory notes discounted and held by them. When the Central Bank fixes its rediscount or bank-rate at a figure lower than what it ought to be other banks also fix their discount and loan rates at lower figures, and traders and manufacturers are encouraged to borrow cheap money from other banks by discounting their bills and promissory notes and other banks are encouraged to borrow more from the Central Bank by rediscounting those bills and promissory notes. The result is that a very large volume of currency comes into circulation and there is inflation or over-issue in the country.

On the other hand if the Central Bank of a country at any time fixes its rediscount or bank-rate at a figure higher than what it ought to be, all other banks also raise their discount, loan and deposit rates. The result is that all who had borrowed before do not try to renew their loans,

those who intended to borrow give up their idea of borrowing at high rates of interest, and those who have any surplus funds deposit them in banks and banks on their turn deposit there surplus funds in the Central Bank. The result is that an excessive volume of currency goes back to the Central Bank and there is deflation or under-issue of paper currency in circulation in the country. Reflation in a country is brought about by its Central Bank by lowering down its rediscount or bank-rate when in the past it was mistakenly maintained at an unduly high figure. Lowering the bank-rate compels other banks to lower down their discount loan and deposit rates and borrowings and withdrawal of traders' funds from banks and of other banks from the Central Bank are encouraged and the result is that as compared to the past more and more currency comes into circulation and the old deficiency or deflation is removed.

One point which must be noted here is that the quantity or volume of currency in circulation at any time in any country is very closely connected with the general price level of its goods and services offered for exchange or with money's purchasing power. Other things remaining the same larger is the volume of currency in circulation in any country at any time, lower is the purchasing power of its money or higher are the prices of general commodities and services and smaller is the quantity of money in circulation in any country at any time, the higher is the purchasing power of its money or lower are the prices of general commodities and services in it. Consequently in a period of inflation the general price level is high, in a period of deflation the general price level is low and in a period of reflation there is a recovery of general price level from a lower to a higher level.

Inflation—It is a state of presence of an excessive amount of currency in circulation in any country at any time, and is either the result of natural causes like a sudden increase in the output of precious metals from mines or their heavy importation, or the result of an artificial increase in currency due to over-issue of paper money. Out of these the first set

of causes occurs rarely. Between 1896 and 1911 prices rose high owing to discovery of gold mines in South Africa.¹

More often inflation is brought about by an over-issue of paper currency in times of grave national emergency like war. At such a time the Government of a country has to find huge amounts of money to meet the abnormal war expenses, but various sources of taxation and public loans inspite of attempts fail to give the required amount of money. Therefore the Government tries to secure more and more money from its Paper Currency Department or the Bank of Issue of the country against its promises to pay in future. The result is that huge amounts of paper money or notes borrowed by the Government come into circulation into the country against its purchases of war materials and services. During the War years of 1914—18 and even for a few years after that, there was a huge inflation of paper currency in many countries of Europe and in India. Even in the present war paper currency is inflated in many belligerent countries, but in India it has developed into a galloping inflation. The following table shows the increase in notes circulation and rise of prices in India since the commencement of the present war.

¹Introduction to Money, Exchange and Banking by R. N. Mathur, page 66.

Table showing Inflation of Currency and Prices in India.
(In Crores of Rupees).

Month	Notes in Circulation	Index of Notes in Circulation August 1939=100	Price Index 19th August 1939=100
1939			
August	170 29	100	100·3
September	186 06	109	112 9
October	199 82	117	114 9
1940			
January	226 35	133	133 2
April	227 78	134	125 0
July	230 71	135	112 1
October	220 20	129	112 1
1941			
January	230·20	135	114 8
April	249 28	146	116 4
July	256 93	151	140 9
October	273 69	160	142 1
1942			
January	328 39	193	145 0
April	401·60	236	145 9
July	419 53	264	161·2
October	508 77	294	175 0
1943			
January	587 60	345	195 6
April	661·55	389	227 9
July	737·00	430	239 3
August	753 53	442	236 0
September	759 75	446	236 3

Figures in the above table have been taken from Oxford Pamphlets on Indian Affairs No. 18, War-Time Prices by Dr. P. J. Thomas

Inflation of currency is usually accompanied by a rise of prices of general commodities. Larger is the inflation of currency in a country, the greater is the rise of prices of its general commodities, and once the evil process has started it continues as a vicious circle unless other factors intervene. From the preceding table it is clear that from September 1939 the amount of notes in circulation in India has been increasing more and more and it has been accompanied by the Indian general price level soaring higher and higher. Every fall in the value or purchasing power of money or a general rise of prices gives some advantage to the traders and manufacturers, who are able to sell their stocks and produce at higher prices and make larger profits, but it causes a grave economic loss to the large numbers of people who are continuously reduced to want and poverty.

"All those persons who have fixed incomes, salaries, wages, etc., find that though their incomes may be the same in money, their real value has suddenly gone down. This class of people cannot increase their incomes easily. True organised wage-earners demand more pay and succeed in the long run in getting it. But this stimulates consumption rather than saving, and leads to still higher prices, thus aggravating the evil. Besides, those persons such as unorganised workers who do not succeed in getting a rise in their money incomes proportionate to the rise in prices must suffer. They must economise or live on past savings, if any. Apart from this, in modern times numerous transactions and contracts which are in terms of money lose their value because of inflation. The nominal value in money of such transactions, which the courts will enforce remains the same, but their value goes down suddenly. It is the experience of such disasters affecting the very basis of modern economic life which the peoples of Europe had in the last War that has made inflation so dreaded, and it is therefore that every government now plans to avoid it. The large amount of money wealth in the hands of some people which is caused by inflation creates a false sense of prosperity in the minds of certain sections of the people. They realise in due course that the real value of their money is

fast going down, and that after all they are not as rich as they imagine. If inflation is allowed to take place, steps have to be taken later by deflationary methods to restore equilibrium. This process as was found by England after 1918, is equally disastrous and painful as it leads to depression and unemployment on a large scale. In an agricultural country which cannot respond to such changes quickly the process will be still more ruinous. If however the inflation goes beyond control there may be no room for any recovery in the ordinary sense as in Germany after the last War."¹

Many people who are not able to meet their expenses out of their present incomes resort to spending their old savings or incur new debts and in both the cases they lose heavily for no fault of theirs. In the former case they are compelled to spend their old savings made at a greater sacrifice, when the value of money was more and general price level lower, in securing a smaller quantity of goods and welfare because the price level is very high. In the latter case the money of debts incurred during the period of inflation and high general prices is spent in obtaining smaller quantities of goods and welfare and is ultimately paid back by denying a larger quantity of goods and welfare, when prices fall in course of time. Many people lose because the capital values of their securities bearing fixed incomes fall down. Moreover in a period of inflation due to false notion of prosperity and high prices many industries crop up, which ultimately meet a cruel death and liquidate when inflation disappears and the normal level of prices is restored. This may make many capitalists a pauper and swell the ranks of idle and unemployed to even dangerous limits. All these arguments make it quite clear that an inflation of currency in any country at any time not justified by her economic reasons does more harm than good to the country, and as far as possible it should be avoided.

Deflation—It is a state of scarcity of currency in circulation in any country at any time. It may be the result of a

¹The Felling Rupee by C. N. Vakil, pages 15 and 16

heavy export of precious metal from the country due to heavy import of goods from abroad compelling contraction of paper currency in circulation or the result of an artificial device to decrease the volume of currency in circulation by raising the bank-rate very high and making credit very dear. Deflation in a country may also be caused by increasing the volume of production of exchangeable commodities and services or by floatation of attractive loans by the Government or Central Bank of the country, whose purchase or subscription by the general public causes a contraction of currency in circulation. During the years 1929-32 there was a heavy deflation of currency in different countries of the world including India both due to contraction of credit and currency and over-production of goods. Deflation may also be done with the object of either correcting some preceding inflation, if any; or purposely undertaken to raise the internal and external value or purchasing power of money of the country.

As inflation is accompanied by a general rise of prices, deflation on the other hand is usually followed by a sudden fall of prices, and larger is the deflation of currency in circulation in any country at any time, greater is the fall of prices of general commodities in that country. Deflation also disturbs the economic life of a country seriously and affects the different classes of people differently. In a period of deflation general prices fall, people who have fixed incomes, salaries, wages, etc., benefit from a fall of the prices for though their money incomes remain the same, their real values go high because their money incomes purchase a larger quantity of goods and services than before. If deflation is carried too far in a country the income of the state may also be affected and the government and other employers may be compelled to reduce the salaries and wages of their employees by heavy retrenchment or cut in salaries and wages. A cut of 10 per cent. in the beginning for about 14 months and subsequently of 5 per cent. was imposed in the salaries of all Government employees in India in the years 1932-1935. Fall of money incomes leads to a further fall of

prices due to smaller purchasing power in the hands of the above people.

Deflation and fall of prices hits the business men very hard, for the selling prices of their stocks and output fall heavily, while their expenses of production are not proportionately reduced. Their burden of taxation and wage payments remains more or less the same. Attempts to cut down wages result in strikes and lock-outs and there is an epidemic of under-employment and un-employment. They lead to a reduction of incomes and contribute towards a further fall of prices. The fate of agriculturists is worst for their incomes fall low, while their fixed money payments such as land revenue, interest on old debts etc., remain more or less the same. In agriculture the production process takes a long time. Several months intervene between the commencement and end of the process of agricultural production. Consequently all calculations of the expenses of production, value of the expected produce and the surplus profit of the producer, become violently upset, when the prices of agricultural produce fall very heavily at the time of harvest.

The burden of all money contracts as well becomes very heavy and debtors lose much far no fault of theirs, and creditors get an unearned increment in the real values of their loans and advances. Thus in a period of deflation a few persons with fixed incomes have a little prosperity, while majority suffers and all round there is a feeling of gloom, distress and helplessness. Moreover due to a constant fear of the fall of prices hanging on the head all enterprise on the part of entrepreneurs becomes sagged. "Indeed it has been said that among the many causes of human retrogression—wars, pestilence, famine bad governments, etc—a long period of falling prices is perhaps the worst because it saps the very sources of human enterprise, deadening the desire to venture and by checking the leaders and most go-ahead sections of the community, stops national progress and jeopardises the position of the whole country."¹

¹Introduction to Money, Exchange and Banking by R. N. Msthur,
page 70

Reflation.—It is a corrective or remedy of deflation. When currency in circulation in any country at any time has been contracted too much or too fast by raising the bank-rate unduly high and making credit extremely dear or is scarce owing to an over-production of exchangeable commodities and consequently all producers particularly traders, manufacturers and agriculturists suffer on account of too low prices, the remedy is reflation. What is bad is not a rise or fall of prices, but when it is too much or too abrupt, it harms the society very seriously. Thus it is essential that even reflation in order to do good should be enforced very carefully and steadily and as soon as its objective has been achieved i.e., the normal price level has been restored, it should at once be stopped.

From the preceding discussion of inflation, deflation and reflation, it is evident that too fast or too heavy changes of the price-level either due to inflation or due to deflation do great harm to a society. The greatest disadvantage of inflation or rise of prices is that it encourages wild speculation in industrial activities and cuts down mercilessly the real incomes of a large number of persons of a society. On the other hand the greatest disadvantage of deflation or fall of prices is that it deadens industrial enterprise and cuts down the money incomes of millions of people by throwing them out of employment either partly or wholly. Both inflation and deflation give only a temporary gain to a few classes at the great sacrifice of the general masses of any society. Consequently in the interest of equity, harmony, welfare and general progress of any society as a whole ; it is essential that as far as possible general prices should remain steady. Professor J. M. Keynes opines that inflation is unjust and deflation is inexpedient.¹ Messrs Wadia and Joshi express the view that, "Industry, trade, commerce, the entire productive machinery on which depends the satisfaction of the fundamental needs of life, presuppose confidence in the stability of prices, confidence in the stability of the monetary

¹ A Tract on Monetary Reform.

unit...There is no nobler work for the enlightened humanity of today than that of controlling money and monetary policy, of regulating the supply of capital and the level of prices and the habits of consumption, in the general interests of mankind."¹

Questions

1 What do you understand from State Issue of paper currency? What are its advantages and disadvantages? Describe them briefly

2. What is meant by Bank Issue of paper currency? What are its advantages and disadvantages? Describe them briefly

3. Compare State versus Bank Issue of paper currency Which of the two is superior and how?

4 Distinguish between Single and Multiple Note Issue systems. Which of the two systems is better and why?

5 What is meant by elasticity of currency? What are the advantages of an elastic paper currency system? Describe them briefly.

6 What do you understand from mobility of currency? What are its advantages? Describe them.

7 Elasticity is a very important attribute of a good paper currency system. Under which system of issue of paper currency possibility of elasticity is the highest? Explain

8. What is meant by inflation of paper currency? How does it affect the different classes of people in a country? Describe

9. What do you understand from deflation of paper currency? What is its effect on the different classes of people in a country? Describe?

10 Distinguish between inflation and deflation of paper currency Which of the two will affect you more adversely and how? Explain.

11. "Reflation is the remedy to an unwise deflation." Comment on the truth of the statement.

12 "Stability of prices of general commodities is the greatest boon to a modern society." Justify the truth of the statement.

¹Money and the Money Market in India by P A Wadia and G. N. Joshi, pages 2 and 3.

CHAPTER IX

PAPER MONEY IN INDIA

Bank Issue. Before 1861 in India paper currency was issued by the Presidency Banks of Bombay, Bengal and Madras, and a few other banks. In those days the banks used to regard this as a very important and profitable business of theirs. But as there was a great multiplicity of notes and the people of India were then not sufficiently acquainted with their use, notes had a very limited local circulation i.e., only in areas served by the issuing banks. Mostly people used metallic currency and indigenous credit instruments called *Hundies*.

State Issue. In 1859 the first Finance Member of the Government of India Mr. Wilson prepared a scheme for the issue of paper currency by the Government. Mr. Wilson was in favour of banking principle of issuing paper currency and in his scheme he provided the same. Unfortunately before his scheme could be considered, he died. Mr. Samuel Laing who succeeded Mr. Wilson favoured currency principle or absolute security of notes issued. In this he was influenced by the Bank Charter Act 1844, which enforced currency principle of note issue on the Bank of England. The then Secretary of State for India also endorsed Mr. Samuel Laing's opinion. Thus the Indian Paper Currency Act 1861 was based on the currency principle of issuing paper currency and its main provisions were as follows :—

Fixed Fiduciary Issue System. (1) The issue of paper currency by the Government of India instead of banks.

(2) A reserve of coin or bullion against the whole of the issue of notes, except an amount not exceeding Rs. 4 crores to be invested in the securities of the Government of India. The effect of this clause was that it allowed no elasticity to the paper currency system of this country.

(3) The lowest denomination of the notes was to be Rs. 10.

(4) For the convenience of issuing notes the country was divided into various circles with presidency towns as the centres of issue.

(5) Notes were to be unlimited legal tender in their own circles of issue for all payments except by Government at its offices and agencies of issue.

(6) The metallic reserve against which notes were to be issued could consist of gold and silver coins of the Government of India and foreign gold coins or bullion.

The system introduced in 1851 on the model of Bank Charter Act 1844 of the Bank of England worked in India up to 1914 without any change in its main feature : *i.e.* its absolute convertibility at the cost of elasticity. Upto 1890 circulation of notes did not increase much but after that date it increased very rapidly. The main reasons of this rapid increase were (1) the issue of Rs 5 note in that year and (2) universalization of the system. In 1903 the Rs 5 note was made legal tender throughout India except Burma and in 1910 notes of the denominations of Rs 5 10 50 and 100 were universalized. Thus with the steady universalization of the notes, the spread of education and confidence, and familiarity with the use of notes, the total circulation of notes went on increasing. The following table shows the growth of gross and active circulation of notes at different times in crores of rupees —

Average Circulation of the year	Gross	Active
1862-63	3 69	
1890-91	15 77	
1900-01	28 88	
1909 10	49 66	37 21
1913 14	65 55	46 63
1918-19	133 2	113 84
1928 29	184 86	171 9
1929 30	183 11	163 0
1930-31	165 49	151 13
1931-32	163 64	152 62
1932 33	173 83	152 04
1933 34	178 13	157 47
1934-35	186 05	166 99

Changes in the limit of fiduciary or invested portion of the Paper Currency Reserve were continually made from 1871 to 1911. Thus the limit of Rs. 4 crores of 1861 became Rs. 14 crores in 1911. From 1905 onward a portion of the fiduciary portion of the Paper Currency Reserve began to be invested in Sterling Securities as well. Before 1893 the Paper Currency Reserve was held in silver coins, but by the Act of that year the Government took the obligation of giving gold coin or bullion in exchange of currency notes. By the Gold Note Act of 1898, the Government of India was authorised to issue notes in India against gold deposited in London with the Secretary of State. This gold in England was utilised in purchasing silver for coinage in India. The Act of 1905 authorised the Government to hold the reserve in rupees, gold coin and bullion, and securities, either in India or in London. Thus the Secretary of State for India began issuing Council Bills against deposits of gold or sterling in London against the issue of notes of an equivalent amount in India. This arrangement then began to support the Indian Foreign Exchange. Thus from 1905 the Paper Currency Reserve held in London began to serve two purposes :—(1) Buying of silver for Indian mints and (2) supporting exchange when the balance of total indebtedness went against India. On the 31st March 1913 the total issue of notes amounted to Rs. 68'97 crores and against this issue the composition of the Paper Currency Reserve was as follows :—

Figures given below are in crores of rupees.

(A). Metallic Reserve :—

Silver in India	Gold in India	Gold in London	Percentage of Metallic Reserve
16'45	29'37	9'15	80%

(B). Fiduciary Reserve :—

Rupee Securities	Sterling Securities	Percentage of Fiduciary Reserve
10	4	20%
<hr/>		
100 per cent.		

In 1913 was appointed the Chamberlain Currency Commission to examine the whole of the currency system of India. Some of the important observations and recommendations of this Commission with regard to the Paper Currency System of India were as follows —

(i) That the Indian Paper Currency was not sufficiently elastic in order to be adequately responsive to the increasing credit needs of her trade and commerce. The restriction imposed upon the currency authority to keep a metallic backing for all notes issued above a fixed minimum was very inconvenient and was becoming more so with the growth of Indian trade and commerce. Provision of issuing notes in India against gold deposited in England under the Gold Act of 1905 did give some elasticity to the Indian Currency system, but this was not adequate as it affected the value of £ in terms of Rupees or India's foreign exchange. Thus with a view to give greater elasticity the majority of members of the commission recommended that (1) the fiduciary portion which stood at Rs 14 crores should be increased at once to Rs 20 crores and thereafter it should be fixed at a maximum of the amount of notes held by the Government in the Reserve Treasuries plus one third of the net circulation (2) as an alternative to investment in permanent Government securities the Government should have the power to make temporary investments or give loans from the fiduciary portion of the reserve both in India and London. In India such loans should be made to the Presidency Banks on prescribed terms (3) the Rs 500 notes should be immediately universalised and facilities should be provided for their encashment.

(ii) As gold in the Paper Currency Reserve is required for purchase of silver in London and maintenance of exchange gold in the reserve in India has been much in excess of the demand. Gold in London is more directly and indubitably effective for this purpose than Gold in India. Thus they recommended that so long as Gold Standard Reserve is itself insufficient to support Indian foreign exchange a suitable portion of gold of the Paper Currency Reserve should be transferred to London.

The commissioners believed that if the above recommendations were carried out the following advantages would result :—

(1) While the permanent addition to the invested portion of the reserve will be no more than is justified by past practice and experience without in any way endangering the complete convertibility of the notes, the revenues of India will secure the profit earned by investing the amount now held idle in the form of gold in India.

(2) In busy trade seasons it would be possible and safe to lend temporarily when permanent investment would be unwise and risky. Power to make loans for temporary periods would enable the Government to earn interest on sums which otherwise may remain idle and at the same time would provide a much needed facility for a temporary expansion of currency in the busy season by which the market might obtain some relief in its monetary stringency.

(3) The power to make temporary investments in London out of Paper Currency Reserve would help the Secretary of State to sell Council Bills against the Paper Currency Reserve, in anticipation of silver purchases or of any other expense without loss of interest, which might sometimes come about, if he were compelled to use the entire proceeds of such sales in keeping gold.

(4) As circulation of notes increases, it would be possible for the authorities to increase the investments of the paper currency reserve in permanent or temporary securities or both without a fresh legislation.

(5) Power to make loans against notes held in Reserve Treasuries would give the Government a profitable medium of counteracting some of the disadvantages arising from the Reserve Treasury System.

Before the recommendations of Chamberlain Commission could be enforced War of 1914-18 broke out and no action was taken on them. During that War time price of silver rose to a very high figure and the difficulty of obtaining sufficient silver for coinage purposes or precious metals as backing for

the issue of additional notes made it necessary to increase the fiduciary or invested portion of the Paper Currency Reserve. Consequently it was raised from time to time by various ordinances and Acts of legislature. Between November 1911 and December 1919 the legal limit of the fiduciary portion was raised to Rs. 120 crores. The Act XXVI of 1919 fixed the limit of the invested portion of the reserve at Rs 120 crores, and out of this Rs 100 crores could be invested in British Treasury Bills. During the same period of 1911 to 1919 the gross circulation of notes increased nearly three-fold, while the percentage of metallic backing decreased by nearly one half.

To increase the note circulation and thus avoid the difficulty of increasing the number of silver rupees in circulation Government had to introduce notes of smaller denominations, and in December 1917 the Rs 2/8/- notes and in January 1918 Rs. 1 notes were introduced. By the Act IV of 1916 investments in British Treasury Bills as part of the Paper Currency Reserve were permitted and by successive Acts they were raised to Rs 100 crores by the end of December 1919. In order to encourage the use of notes and discourage the use of silver rupees, several restrictions were placed on the encashment of notes, the transport of specie by rail or river was prohibited, and an embargo was placed on its transmission, by post. Demands for encashment of notes even at currency offices were not met in full and without limit. The result of these restrictions was that notes substituted silver rupees as the common circulating medium to a large extent, but owing to loss of confidence these notes were in circulation at a discount as high as 19 per cent. in some places¹. This loss of confidence rapidly diminished and later on notes were accepted freely.

Proportional Reserve System—In 1919 was appointed the Babington Smith Committee and in order to give greater elasticity to the paper currency system of India that committee recommended —

¹History of Indian Currency and Exchange by Dadachandji, B. E., p 220.

(1) Instead of fixing the fiduciary portion of the Paper Currency Reserve at a certain maximum figure, the legislature should prescribe that, it shall not exceed a maximum percentage of the total issue (or alternatively, that the metallic portion of the reserve shall not fall below a minimum percentage of the total issue). By doing so they said, it would obviate the necessity of making constantly fresh applications to the legislature to enhance the limit of the fiduciary portion as the circulation grows. They recommended that the fiduciary portion of the Paper Currency Reserve should not exceed 60 per cent. of gross circulation.

(2) In order to meet the seasonal demand for additional currency, it should be possible for the currency authority to issue Rs. 5 crores of notes over and above the normal fiduciary issue as loans to the Presidency Banks on the security of export bills having a maturity of not more than 90 days. ✓

~~while in the same manner there~~
(3) That the holding of securities issued by the Government of India in the Paper Currency Reserve should not exceed Rs. 20 crores.

(4) That the remainder of the fiduciary portion should consist of securities of other governments within the British Empire, redeemable at a fixed date of which all except Rs. 10 crores should be short dated securities maturing within one year.

(5) That the metallic portion of the Reserve should be held in India except for transitory purposes.

The Indian Paper Currency Act No. XLV of 1920 gave effect to the recommendations of the Babington Smith Committee. The Act provided for:—(1) The issue of currency notes against sovereign and half-sovereign at the new rate of Rs. 10 per sovereign and against gold bullion at the corresponding rate of one rupee for 11'33016 grains troy of fine gold. (2) The metallic portion of the reserve was to be not less than 50 per cent. of the currency notes in circulation (instead of 40 per cent. as recommended by the Babington Smith Committee). In other words, the invested or fiduciary

portion of the reserve was not to exceed the value of the metallic reserve. (3) The gold held by the Secretary of State shall not exceed Rs. 5 crores. (4) In the securities portion of the reserve the Government of India securities shall not exceed Rs. 20 crores. Not more than Rs. 12 crores of this amount may be in securities created by the Government of India commonly called as ad hoc securities. The object of these specially created securities was to make up the difference which had arisen in the value of sterling securities due to their revaluation at the new rupee rate of 2 shillings instead of the older rate of 1s. 4d. On actual revaluation of the Reserve this limit had to be exceeded considerably. Therefore it was further enacted that as long as the created securities exceeded the limit of Rs. 12 crores all interest on the securities of the Paper Currency Reserve as well as on securities in the Gold Standard Reserve was to be utilised for the reduction of the amount of the above created securities. (5) The amount of notes to be issued against discount of commercial bills maturing not later than 90 days from the date of their issue was fixed at Rs. 5 crores as maximum.

From September 1920 Indian foreign exchange began to fall very heavily. To strengthen exchange the Government adapted the policy of heavy deflation of paper currency. This brought about a great stringency of money in the Indian money market. To meet the difficulty the Government took power under Section 20 of the Indian Paper Currency Act 1923 to issue emergency currency to the extent of Rs. 12 crores against commercial bills endorsed by the Imperial Bank. Rules laid down for the issue of this emergency currency against bills of exchange were:—

(1) Loans shall be given to the Imperial Bank of India only when the Bank Rate rises to 6 per cent. and not below it, and that

(2) when the Bank Rate is below 7 per cent a maximum of Rs. 4 crores should be issued, second Rs. 4 crores when the Bank Rate is 7 per cent., and last Rs. 4 crores when the Bank Rate is 8 per cent.

In September 1924 the above rules under which loans were granted to the Imperial Bank of India were changed by an announcement so as to make it possible for the Bank (1) to borrow Rs. 4 crores when the Bank Rate was 6 and (2) Rs. 8 crores when the Bank Rate was 7 per cent. In September 1925 the situation of paper currency and its reserves was as follows :—

Gross Note Circulation	Percentage of Metallic Reserve	Percentage of Fiduciary Reserve
Rs. 189'51 Crs.	59'3%	40'7%

Bank Issue and Proportional Reserve System.—In 1925 was appointed the Hilton Young Currency Commission, and with regard to the paper currency system in India, they made the following recommendations :—

(1) Convertibility of Notes into Silver Rupees: Convertibility of notes into silver rupee under statutory obligation is an anomalous provision for under it one form of note, the paper note, is convertible into another form, the silver note. It has in the past placed the currency system of the country completely at the mercy of the price of silver. Prudence demands that such a risk should be provided against if possible. By making notes convertible into gold bars for all purposes, a more solid right of convertibility is attached to them than they have ever had. Moreover it will enable silver to be eliminated as a predominant element from the paper currency reserves, which would thereby be simplified and placed on a sounder basis than they were ever before.

(2) Issue of One Rupee Note: We recommend that the currency authority should re-introduce one-rupee notes, which should be full legal tender and which like other notes of the new status should not compulsorily be convertible by law into silver rupees.

(3) Convertibility of Other Notes into Legal Tender Money: When the present legal right to obtain silver rupees in exchange for notes is withdrawn, a statutory obligation on the currency authority be imposed to convert all notes, other than the one-rupee note, on demand into legal tender money,

i.e., into notes of smaller denominations or silver rupees at the option of the currency authority

(4) **Unification of the Paper Currency and the Gold Exchange Standard Reserves** Experience has shown that it is impossible to discriminate scientifically between the purposes for which the Paper Currency and Gold Standard Reserves are maintained. The Paper Currency Reserve has to be used in some measure to support exchange and the Gold Standard Reserve has to be used in some measure to secure the external convertibility of the note. With the removal of the convertibility of the notes into silver rupees the way will be clear for the amalgamation of the two reserves. The combined reserve will then be simpler and more intelligible to the public and can be made more efficient in its working. Composition and proportions of the combined reserve should be fixed by statute. This provision is essential to any currency system in order to secure the automatic expansion and contraction of the currency and the compensatory effect of the exchanges in accordance with the needs of the country. Gold and gold securities should form not less than 40 per cent of the reserve in view of the obligations to provide gold bars in exchange of internal currency and attempt should be made to increase the gold holding in the reserve to reach the limit of 25 per cent. Silver holding in the reserve should continually and gradually be reduced to Rs 25 crores. Fiduciary portion of the reserve may be held in Government of India securities or self liquidating trade bills but the holding of the Government of India securities be limited to 25 per cent of the reserve or Rs 50 crores which ever is less.

(5) The Indian Currency System has an inherent weakness in which the control of currency and of credit is in the hands of two distinct authorities whose policies may be widely divergent and in which the currency and banking reserve are controlled and managed separately one from the other. If monetary stability is to be achieved a unity of policy in the control of currency and credit is necessary in a modern

financial organisation of a country. Thus we recommend the establishment at an early date of a Central Bank for India with the sole right of issuing paper currency, a responsibility of maintaining the stability of the currency, and stoppage of all further issues of notes by the Government of India except through the above Bank.

(6) In order to give additional elasticity to the currency system of India the Commission recommended the adoption of the Proportional Reserve System instead of the Fixed Fiduciary System. The Bank of England issues paper currency and maintains the paper currency reserve under a fixed fiduciary system adopted under the Bank Charter Act of 1844 and as amended by the Currency and Bank Notes Act of 1928. In England the system has worked well because as compared to India there is not such a great variation in the demand of currency at different seasons of the year. India is an agricultural country and consequently the demand of currency at different seasons of the year is widely different. Moreover in India the cheque system is also not so much developed as it is in England. Hence expansion and contraction or elasticity of currency is much more needed in a country like India than in industrially and commercially advanced countries of the world such as United Kingdom, U.S.A., etc.

Proportional Reserve System is in operation in many countries of the continent of Europe, U.S.A., and South Africa. Under this system notes in active circulation are secured by a statutory minimum percentage of gold holding, but this minima is not rigidly fixed. It may be transgressed with the consent of the government for short periods of time on condition that the issuing bank pays a tax reckoned on the amount of the deficiency. This tax is made to rise steeply as the deficiency increases. The restrictions imposed in the form of government permission and tax rising steeply, force the bank to take prompt measures to redress the situation by an appropriate credit policy. Under this system usually the limit fixed for the metallic portion of the reserve is 40 per cent. of the notes in circulation. The chief characteristic of this system is that expansion and contraction do not, as in the

coins which are legal tender under the Indian Coinage Act 1906, in such quantities as may, in the opinion of the Bank, be required for circulation, and the Governor-General in Council shall supply such coins to the Bank on demand. If the Governor-General in Council at any time fails to supply such coins, the Bank shall be released from its obligations to supply them to the public.

(8) Recovery of Notes Lost, Stolen, Mutilated, Imperfect: No person shall of right be entitled to recover from the Bank or the Governor-General in Council the value of any lost, stolen, mutilated, or imperfect currency note or Bank note

(9) The Bank shall not be liable to the payment of any stamp duty under the Indian Stamp Act 1899, in respect of Bank Notes issued by it.

(10) If at any time the Bank fails to comply with any provision of this Act with regard to the paper currency, the Governor-General-in-Council may declare that the Bank has forfeited the right of note issue and shall thereupon take over the liabilities of the Issue Department, together with such portion of the assets of the Bank as is required to meet such liabilities.

(11) No person in British India other than the Bank shall draw, accept, make, or issue any bill of exchange, *hundis*, promissory note, or engagement for the payment of money payable to bearer on demand or borrow, owe or take up any sum or sums of money on the bills, *hundis*, or notes payable to bearer on demand of any such person.

(12) Constitution of the Paper Currency Reserve: The assets of the Issue Department shall consist of (a) gold coin, gold bullion, sterling securities, and (b) rupee coin and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department.

Of the total amount of the assets, not less than two-fifths shall consist of gold coin, gold bullion or sterling securities; provided that the amount of gold coin and gold bullion shall not at any time be less than forty crores of rupees in value. The remainder of the assets *i.e.*, 60 per cent. or three-fifths

shall consist of rupee coin, Government of India rupee securities of any maturity and bills of exchange and promissory notes as hereinafter defined :—

(a) Bills of exchange and promissory notes drawn on and payable in India and arising out of *bonafide* commercial or trade transactions bearing two or more good signatures, one of which shall be that of a scheduled bank, and maturing within ninety days from the date of their purchase or rediscount, exclusive of days of grace ;

(b) Bills of exchange and promissory notes, drawn and payable in India and bearing two or more good signatures, one of which shall be that of a scheduled bank, or a provincial co-operative bank, and drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and maturing within nine months from the date of their purchase or re-discount exclusive of days of grace ;

(c) Bills of exchange and promissory notes payable in India arising out of *bonafide* commercial or trade transactions, or to finance the seasonal agricultural operations or the marketing of crops and maturing within 90 days or 9 months respectively as necessary, purchased or discounted by the Bank directly, when in the opinion of its Central Board it is necessary, or expedient that that action should be taken for the purpose of regulating credit in the interests of the Indian trade, commerce, industry, and agriculture.

(d) The amount held in Government of India rupee securities shall not at any time exceed one-fourth of the total amount of the assets or fifty crores of rupees, whichever amount is greater, or with the previous sanction of the Governor-General in Council, such amount plus a sum of 10 crores of rupees.

(e) For the purposes of the above provisions, gold coin and gold bullion shall be valued at 8·47512 grains of fine gold per rupee, rupee coin shall be valued at its face value, and securities shall be valued at the market rate for the time being obtaining.

(f) Of the gold coin and gold bullion held as assets, not less than seventeen-twentieths shall be held in British India, and all gold coin and gold bullion held as assets shall be held in the custody of the Bank or its agencies. Provided that gold belonging to the Bank which is in any other bank or in any mint or treasury or in transit may be reckoned as part of the assets.

The securities of a sterling standard country which may be held as assets in the paper currency reserve shall be the securities of any of the following kinds payable in the currency of the United Kingdom, namely:—

(a) balances at the credit of the Issue Department with the Bank of England;

(b) bills of exchange bearing two or more good signatures and drawn on and payable at any place in the United Kingdom and having a maturity not exceeding ninety days;

(c) Government securities of the United Kingdom maturing within five years.

Ordinarily the Bank will hold rupee coins in the paper currency reserve to the extent of rupees fifty crores or one-sixth of the total amount of the reserve, but after the close of any financial year if the rupee coin held in the assets, as shown in any of the weekly accounts of the Issue Department for that year is greater than fifty crores of rupees or one-sixth of the total amount of the assets as shown in that account, whichever may be the greater, the Bank may deliver to the Governor-General in Council rupee coin up to the amount of such excess but not without his consent exceeding five crores of rupees, against payment of legal tender value in the form of bank notes, gold, or securities: Provided that if the Bank so desires and if the amount of gold coin, gold bullion and sterling securities in the assets does not at that time exceed one-half of the total assets, a proportion not exceeding two-fifths of such payment shall be in gold coin, gold bullion or such sterling securities as may be held as part of the assets. On the other hand if after the close of any financial year in which the maximum amount of rupee coin held in the assets,

as so shown, is less than fifty crores of rupees or one-sixth of the total amount of the assets, as so shown, whichever may be greater, the Governor-General in Council shall deliver to the Bank rupee coin up to the amount of such deficiency but not without its consent exceeding five crores of rupees, against payment of legal tender value.

Suspension of assets requirements. The bank may, with the previous sanction of the Governor-General in Council, for periods not exceeding thirty days in the first instance, which may, with the like sanction, be extended from time to time by periods not exceeding fifteen days, hold as assets gold coin, gold bullion or sterling securities of less aggregate amount than that required or 40 per cent; but in respect of any period during which the holding of gold coin, gold bullion and sterling securities is reduced, the Bank shall pay to the Governor-General in Council a tax upon the amount by which such holding is reduced below 40 per cent; and such tax shall be payable at the bank rate for the time being in force, with an addition of one per cent. per annum when such holding exceeds thirty-two and a half per cent of the total amount of the assets and of a further one and a half per cent per annum in respect of every further decrease of two and a half per cent or part of such decrease: Provided that the tax shall not in any event be payable at a rate less than six per cent. per annum. This provision is made to give additional elasticity to the paper currency system of India. It is an essential feature of the proportional reserve paper currency system of a country.

Liabilities of the Issue Department. The liabilities of the Issue Department shall be an amount equal to the total of the amount of currency notes of the Government of India and bank notes for the time being in circulation. Any currency note of the Government of India or bank note which has not been presented for payment within forty years from the 1st day of April following the date of its issue shall be deemed not to be in circulation, and the value thereof shall be paid by the Issue Department to the Governor-General in Council or the Banking Department, as the case may be; but any

such note, if subsequently presented for payment, shall be paid by the Banking Department and any such payment in the case of a currency note of the Government of India shall be debited to the Governor-General in Council.

The Reserve Bank of India was floated in March 1935 and it began to function from April 1, of that year on which date the Bank took over the control of the Note Issue Department from the Government and the management of Public Debt and Government accounts from the Imperial Bank. Since July 1, 1935 the Bank began to function in its Banking Department and as a Control Bank. The capital paid-up is Rs 5 crores in shares of Rs 100 each. In accordance with Section 47 of the Reserve Bank of India Act 1934 the Governor-General in Council fixed a cumulative rate of dividend to share holders at $3\frac{1}{2}$ per cent. per annum and the Bank has been paying dividend all these years to share-holders and the surplus profit to the Governor-General in accordance with the above Section. The Bank Rate which was fixed by the Bank at 3 per cent on November 28 1935 has remained unchanged all these years. In Feb 1943 the Bank issued also a note of Rs 2 denomination. The Bank's obligation to issue rupee coin on demand in exchange of its notes has temporarily been suspended by the Central Government Notification No 494 OR/40, dated the 25th June 1940 issued under the Defence of India Act. On pages 175 and 176 are given the Statements of Affairs of the Bank of April 5, 1935 i.e. the date on which the Bank issued its first Statement of Affairs after inauguration, of 31st December 1938 i.e. before the commencement of the present world war, and as on December 31, 1943 i.e. about 4 years after the commencement of the present war. They give an idea of the working of the Bank and the huge inflation of paper currency accompanied by a huge accumulation of Sterling Securities as a part of the Paper Currency Reserve during these years of the present world war.

STATEMENT OF AFFAIRS
Reserve Bank of India
ISSUE DEPARTMENT

Liabilities.	5th April, 1935.	31st Decem- ber, 1938.	31st Decem- ber, 1943.	Assets.	5th April, 1935.	31st Decem- ber, 1938.	31st Decem- ber, 1943.
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Notes held in the Bank- ing Department ...	19,05,29,000	18,43,69,125	9,59,72,000	A. Gold Coin and Bullion			
Notes in Circulation ...	1,66,99,97,000	187,99,59,668	8,40,80,16,000	(a) Held in India ...	41,55,19,000	41,54,53,252	44,41,43,000
				(b) Held outside India	2,86,98,000	2,86,97,742	...
Total Notes Issued ...	1,86,05,25,000	206,43,29,093	850,39,88,000	Sterling Securities ...	48,62,95,000	59,50,02,402	734,83,96,000
				Total of A ...	93,06,12,000	103,91,53,436	779,25,39,000
				B. Rupee Coin ...	49,94,95,000	70,19,36,609	12,81,84,000
				Government of India Rupee Securities.	43,05,19,000	32,32,39,048	58,32,65,000
				Internal Bills of Exchange and other Commercial Paper.	...	...	...
				Total Assets ...	1,86,05,26,000	206,43,29,093	850,39,88,000
Total Liabilities ...	1,86,05,26,000	206,43,29,093	850,39,88,000	Ratio of Total A to Liabi- lities.	50.013 p. c.	50.339 p. c.	91.634 p. c.

BANKING DEPARTMENT

Liabilities.	5th April 1936	31st Decem-ber 1938	31st Decem-ber 1943	Assets	5th April 1935	31st Decem-ber 1938	31st Decem-ber 1943
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Capital Paid up	5 00 00 000	5 00 00 000	5 00 00 000	Notes	19 05 29 000	18 43 69 425	9,69 72 000
Reserve Fund	5 00 00 000	5 00 00 000	5 00 00 000	Rupee Coin	3 30 000	3 79 219	17 93 000
Deposits—				Subsidiary Coin	1 04 000	6 59 976	1 60 000
(a) Government	18 38 41 000	11 18 53 088	24 28 00 000	Bills Discounted—			
(b) Banks	7 82,07 000	12 17 43 68	90 17 9 000	(a) Internal			
(c) Others		84 33 920	7 16 87 000	(b) External			
Bills Payable	43,000	8 77 94	3 37 87 000	(c) Government of India Treasury Bills		8 26 46 250	2 25 000
Other Liabilities	1 85 000	86 87 974	6 81 38 000	Balances held abroad	11 91 90 000	1 14 08 434	120 60 000 000
				Loans and Advances to the Government		1 06 00 000	26 00 000
				Other Loans and Advances		10,50 000	18 5 000
				Investments	5 00 00 000	5 26 15 758	7 68 53 000
				Other Assets	16 18 000	78 83 983	3 25 34 000
Total Liabilities	36,20 76,000	55 15 98 014	141 82 11,000	Total Assets	36 00 76 000	55 15 98 014	141 18 11 000

Questions

1. Describe briefly the system of paper currency in India before 1861. Point out its main defects.
2. Describe briefly the important changes that were made in the Indian Paper Currency System under the Paper Currency Act of 1861.
3. Trace the history of Indian Paper Currency from 1861 to 1919 and point out its main defects.
4. What were the main recommendations of the Chamberlain Currency Commission of 1913 with regard to the paper currency system of India and how far had they been enforced by the Government of India ? Describe.
5. Describe briefly the main difficulties that led to the appointment of the Babington Smith Currency Committee. What were the main recommendations of that Committee for the improvement of Indian Paper Currency system and how far had they been accepted and enforced by the Government of India ?
6. When and under what circumstances did India adopt the Proportional Reserve System of issuing paper currency ? Describe.
7. Describe briefly the main recommendations of the Hilton Young Currency Commission of 1925 with regard to the paper currency system of India.
8. Trace the history of the establishment of the Reserve Bank of India since 1925 and explain the main improvements that have been made by it in the Indian paper currency system.
9. What were the main defects of Indian paper currency system before the establishment of the Reserve Bank of India ? How far have they been removed by the Reserve Bank ? Describe.
10. What provisions have been made in the Reserve Bank of India Act 1934 to insure elasticity of Indian paper currency ? Describe them.
11. What are the rights of a holder of a Rs. 100 note of the Reserve Bank of India so far as its convertibility is concerned ? Describe them briefly.
12. What do you understand from the Statement of Affairs of the Issue Department of the Reserve Bank of India ? Prepare one by way of specimen and explain its various items.
13. What are the main defects of the present Indian paper currency system ? Explain them fully.
14. What are the present day one rupee notes ? When were they issued and by whom ? What are the rights of their holders ? Explain briefly.
15. What is the responsibility, if any, of the Government of India with regard to the notes issued by the Reserve Bank of India ? Describe.

CHAPTER X

GRESHAM'S LAW

No account of money is complete without a discussion of the Gresham's Law. In simple words this law can be expressed as follows :—'if at the same time in a country coins of the same metal, but of different weights or quality circulate at the same exchange value, the worse coins will tend to drive away the better ones from circulation, but the better will never drive out the worse.' Gresham's Law is named after an Elizabethan Knight, who is supposed to have infused the idea in a Royal Proclamation in which the law found expression for the first time. Although the law was first published in the time of Elizabeth's reign, it was not generally recognised until long after. The currency authorities in those days could not understand as to why should people prefer in circulation light weight or debased coins as compared to those of full-weight or new coins. Whenever the authorities issued new full weight coins they hoped that they will displace the old debased coins already in circulation; but to their utter disappointment they always found that just the reverse of their expectations happened. Old and debased coins remained in circulation and the new full weight coins issued were soon driven out of it. A little reflection will show that what happened was quite in accordance with human nature.

Coins are made to circulate freely from hand to hand among the people of a country. This is an essential feature of coins; but when a man has to part with anything, he naturally parts with the least valuable, provided it will exchange for as much as the more valuable article. We must remember that until modern methods of banking developed, people generally saved money by hoarding coins and in doing so they always preferred the rewest, heaviest and more valuable coins, because the possession of a lighter coin meant a probable loss to the owner. Thus in circulation remained only lighter coins and all new, heavy and more

valuable coins went out of circulation and were either hoarded or exported in the form of coins or bullion. This is only one way in which Gresham's Law can operate.

Gresham's Law operates not only when coins of the same metal but of varying weights or quality are put into circulation at the same value, but also when coins of two metals are put into circulation at the same nominal value but their real or intrinsic values differ. Thus it may be noted that really the point is not that the coins are made of the same metal or, of different metals, but the point is that when in circulation there are two kinds of coins and they circulate at the same nominal value though their real or intrinsic values differ people begin to hoard the more valuable coins and pass on to others or keep in circulation only the less valuable ones. Similarly the law also operates when coins of two metals are put into circulation at a fixed ratio of exchange with one another, but the relation of their market values differs from the official ratio. In such a case the coins of the overvalued metal drive out of circulation the coins of the undervalued metal.

It must be noted that it is not that Gresham's Law can operate only in connection with coins or metallic currency. If in any country at any time metallic and paper currency both are in circulation as unlimited legal tender and the paper currency is highly inflated and inconvertible, people begin to hoard metallic currency and keep paper currency only in circulation. Thus coins or metallic currency is driven out of circulation by the paper currency of the country. During the years 1919 to 1923 this thing happened in Germany, when paper currency became irredeemable. From the time that the present world war has broken out, this tendency to hoard silver coins and keep in circulation only paper currency is also noticeable in India. Thus we see that the operation of Gresham's Law is not limited only to metallic currency but it applies to paper currency as well. Further if in any country at any time some notes are more convertible than others, but both of them are unlimited legal tender, the same law will begin to operate. Notes which are more con-

vertible than others will be hoarded and in circulation will remain only notes which are less redeemable. But if the two forms of paper currency are not legal tender and their acceptance in circulation is left to the choice of the people then good money will drive away the bad money out of circulation.

Conditions which Check the Operation of the Gresham's Law

(1) *Absolute confidence in redeeming capacity of those who have issued the less valuable currency.*

(2) *Inability to hoard or save.* If people are not able to save and have to spend all that they get, the question of hoarding and the operation of Gresham's Law does not arise.

(3) *When the total quantity of money in circulation in a country is less than or according to its demand Gresham's Law cannot operate.*

(4) *Development of deposit banking which discourages hoarding habit checks the operation of Gresham's Law.*

We have already examined the conditions under which Gresham's Law operates and it is evident from them that the law operates only when there are in circulation in any country at any time two forms of money both of which have the same exchange value though intrinsically one is more valuable than another. In such a case people try to pass on in payment to others inferior money and keep the superior money with themselves for they have no confidence that whenever they like they can get in exchange of their inferior or debased money full weight money from the currency authorities of the country. This lack of confidence creates in the minds of the people an apprehension that in case they keep with themselves the debased or inferior money and pass on superior or full-weight money to others they might lose in future owing to the inability or unwillingness of the currency authorities to redeem the former at their full exchange value. This is generally the case when the government of a country which is usually also the currency authority is not sufficiently

strong and stable or its currency policy is not either well defined by statute or has not been uniformly maintained by the government. On the other hand if in any country these conditions do not exist or people have absolute confidence in the government or the currency authorities of the country, Gresham's Law will not operate. If people know that whenever they like they can get full exchange value of their debased or inferior money from the currency authorities of the country, they will not be very keen to keep with them only full weight coins or superior money. It will be quite immaterial to them whether they keep their savings in the form of inferior or superior money and consequently Gresham's Law will not operate or operate only with a very insignificant force.

Another contributory condition of the operation of Gresham's Law in any country is the people's capacity to save and hoard. If the incomes of the people of a country are such that after meeting their total expenditure they are able to save something every month, year or any other period, there can be a question of making a selection of the coins or money to be saved and spent and if this is accompanied by lack of people's confidence in the currency authorities of the country there is every possibility of the operation of Gresham's Law. On the other hand if the incomes of the people are small, they are poor, have a hand to mouth living, and are always in difficulty of making the two ends of their budgets meet, there will be very small chances for the people to make selection of the coins or money to be saved and spent. If people have to spend all that they earn and have no or extremely small savings, there are very meagre possibilities of the operation of Gresham's Law. Thus the operation of Gresham's Law or otherwise depends also upon the nature and extent of a country's people's capacity and willingness to save.

A third condition under which Gresham's Law can not operate in any country in spite of the existence of both bad and good coins in circulation at the same time is the strict limitation of the supply of money in the country according to the

demand In every country at a certain time trade commerce and industry require a certain quantity of money to meet their demands Thus if in any country at any time there are both bad and good coins in circulation but all of them put together are only in such a quantity that they can hardly meet the demands of the country's trade commerce and industry they will all circulate together Good coins will not disappear and both good and bad coins will remain in circulation because owing to a great demand people will not be able to withhold better coins from circulation

A fourth condition that would check or discourage the operation of Gresham's Law in a country is the presence of a suitable and attractive system of deposit banking into that country When Gresham's Law operates people save superior money or full weight coins and store them in hoards or chests in order that they may be available to them for use in future Thus if in any country deposit banking is not properly developed and hoarding in chests or underground is the only method of storing savings people will naturally select better or full weight coins for this purpose On the other hand if modern methods of deposit banking or investments in various types of securities are available to the people of a country in a suitable and sufficiently attractive manner the operation of the Gresham's Law would be checked or discouraged If people have to put their savings in banks or invest in securities it is immaterial to them whether they deposit or invest full weight coins or superior money or the debased coins or inferior money for both the full value and debased money shall be accepted by banks or borrowers at the same nominal value Even if a person deposits in a bank or invests in a security full weight new coins or superior money there is no guarantee that the same would be returned to him at the time of repayment Therefore development of deposit banking and suitable sources of investment in securities in a country discourage and check the operation of Gresham's Law to a very great extent

From the above discussion it is evident that Gresham's

Law operates only under certain conditions and its significance was great when currency and coinage in different countries of the world consisted only of metal and were not properly organised and deposit banking had not developed. The law has little force now, not because the truth has undergone any change, but because modern methods of currency and banking do not afford conditions for its working with any great force, though in abnormal times like war etc., its operation to some extent is visible even now.

Questions

1. What is Gresham's Law? Under what conditions does it operate? Explain briefly.
2. 'Bad money drives away good money out of circulation.' Explain the truth of this statement.
3. What factors check the operation of Gresham's Law in any country inspite of the existance of conditions favourable for its operation? Describe fully.

CHAPTER XI VALUE OF MONEY

We have already seen before that money acts as the standard of values and medium of exchange of all other commodities and services of a country. The value of all vendible commodities and services are measured and expressed in terms of money. The values of various commodities expressed in terms of money are known as prices. As money measures and expresses the values of all other commodities of a country, there is a difficulty in finding a suitable measure of expressing the value of money. There is no suitable medium in which the value of money itself may be expressed correctly and conveniently. There is no single commodity in whose terms the value of money may be expressed quite accurately. Consequently as money measures the values of all other commodities, the value of money itself can be measured only in terms of all other commodities against which it generally exchanges. Thus the value of money is its general power of purchasing the other commodities and it can be measured and expressed only in terms of those general commodities,

General commodities are thousands in number and the measurements of expressing their different quantities are also widely different from each other. These measures of different quantities of different commodities differ from commodity to commodity, country to country and sometimes in the same country from one locality to the other. Hence the term general commodities is very indefinite and there can not be any single measure in whose terms its quantities may be expressed. For these reasons it is not possible to express the value of money in terms of general commodities at any particular time. For example suppose we want to calculate the value of one rupee in terms of general commodities at any particular date, week, month or year, it cannot be done in any intelligible way. Consequently the procedure of calculating the value of money in terms of general commodities is adopted only in order to compare its value or general power of purchasing other commodities at two different times. Usually this method of measuring variations in the general purchasing power of money is by the use of index numbers of prices at different times.

"An index number is a number which represents the price of a chosen commodity, or group of commodities, or the average of closely consecutive prices of those commodities, at a selected date which is used as a standard where with we may compare the prices of the same article at later dates."¹ In order to determine changes in the value of money or its general purchasing power at different times, it is better to take the average or the sum of prices of a number of different articles, instead of taking the price of a single article as a standard. Now for price or prices of the starting or basic period we suppose the figure 100. This number 100 may represent either the average of prices of a given year or that of several years. The averages of prices of subsequent years whether higher or lower than the average of the basic year or years can be expressed by the relations they bear to 100 which is the base. The following tables illustrate the procedure of working out index numbers of prices at different times

First Method

VALUE OF MONEY

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Commodities	1923		1933		1943	
	Prices	Index Numbers. Basic Period	Prices.	New Index Numbers.	Prices.	New Index Numbers.
	Rs. as.		Rs. as.		Rs. as.	
Wheat per maund ...	5 0	100	2 8	$\frac{100 \times 5}{5 \times 2} = 50$	12 0	$\frac{100 \times 12}{5} = 240$
Rice per maund ...	5 0	100	4 0	$\frac{100 \times 4}{5} = 80$	16 0	$\frac{100 \times 16}{5} = 320$
Pulses per maund ...	4 0	100	3 0	$\frac{100 \times 3}{4} = 75$	10 0	$\frac{100 \times 10}{4} = 250$
Sugar per maund ...	20 0	100	10 0	$\frac{100 \times 10}{20} = 50$	16 0	$\frac{100 \times 16}{20} = 80$
Milk per seer ...	0 4	100	0 2	$\frac{100 \times 2}{4} = 50$	0 6	$\frac{100 \times 6}{4} = 150$
Ghee per seer ...	1 4	100	1 0	$\frac{100 \times 4}{5} = 80$	4 0	$\frac{100 \times 4 \times 4}{5} = 320$
Cloth per yard ...	1 0	100	0 12	$\frac{100 \times 3}{4} = 75$	3 0	$100 \times 3 = 300$
General Index Numbers ...		$\frac{700}{7} = 100$		$\frac{460}{7} = 65.71$		$\frac{1660}{7} = 237.14$

Second Method

Commodities.	1923. Prices	1933 Prices	1943 Prices
	Rs as p	Rs as p.	Rs os. p
Wheat per maund ...	5 0 0	2 8 0	12 0 0
Rice per mound ...	5 0 0	4 0 0	16 0 0
Pulses per maund ...	4 0 0	3 0 0	10 0 0
Sugar per maund. ...	20 0 0	10 0 0	16 0 0
Milk per seer. ...	0 4 0	0 2 0	0 6 0
Ghee per seer. ...	1 4 0	1 0 0	4 0 0
Cloth per yard .	1 0 0	0 12 0	3 0 0
Total price of 7 units of general commodities.	36 8 0	21 6 0	61 6 0
Average price of 1 unit of general commodities.	5 3 5	3 0 10	8 12 3
General Index Numbers with 1923 as Basic Year.	100 0 0	58 54	168 13

In the above tables the figures of prices are purely imaginary. According to the first method in 1923, the first date selected, the price of each commodity is supposed as 100. Hence the simple average of the prices of basic year is 100. In 1933 and 1943 the prices having changed and reduced to 100 of basic year, the averages of prices become 55.71 and 237.14. That is, as compared to 1923 the average of prices or the general price level, as estimated according to these commodities, was 34.29 per cent lower in 1933, and 137.14 per cent higher in 1943. Thus we see that if in 1923 we could get one unit of general commodities for 100 units of money, then in 1933 and 1943 for the same one unit of

general commodities we were required to pay 65'71 and 237'14 units of money respectively, *i.e.*, as compared to 1923 in 1933 value of money was higher and in 1943 it was lower. In the second method, instead of regarding the price of each commodity in the basic year as 100, we simply add the actual prices of all the selected commodities of each year and divide the result by the number of commodities and it gives the price of one unit of general commodities of each selected year. These figures show the courses of averages and their ratios according to the preceding second table are Rs. 5/3/5 : Rs. 3/10 : Rs. 8/12/3. Now regarding the first average of Rs. 5/3/5 of 1923 the basic year as 100, the other averages of 1933 and 1943 of Rs. 3'/10 and Rs. 8/12/3 would be 58'54 and 168'13 respectively. These figures also show that as compared to 1923 the value of money in 1933 was higher and in 1943 was lower. No doubt the working of the same prices according to the above two methods gives different results, but the courses of prices or changes in the value of money as indicated by both the methods are the same.

Defects and Difficulties of Index Numbers

It has already been said before that it is almost impossible to calculate the value of money in terms of a fixed quantity of general commodities at any given time. The method of measuring changes in the value of money or its general purchasing power by means of index numbers of prices can usefully be employed only for purposes of comparison *i.e.*, in order to find out fluctuations in the value of money from time to time. For this purpose it is necessary that index numbers of prices should be accurately calculated. The degree of preciseness of the index numbers of prices as correct measure of changes in the value of money depends upon the suitability of the selected basic year, the kind of average used in computing the base, upon the number of commodities selected, upon the quantity of each commodity, upon the kind of prices used whether wholesale or retail, upon the correctness of record of each price, upon the extent of territory within which the prices recorded are applicable, etc.

Firstly it is essential that the year selected as basic year should be a normal year for otherwise comparisons of index numbers of all subsequent periods would give misleading results. Different institutions adopt different years as basic year, but usually 1913 is used as the basic year. In India the official basic year is 1873. Secondly the kind of average used in computing the base is important. An average can be calculated in several ways *e.g.*, arithmetical, geometric, harmonic, median, etc., but arithmetical average is very common. Thirdly as money expresses the values of all other commodities and services, the number of commodities selected should be as big as possible. The longer is the list of commodities selected, the nearer we will be in our correct estimation of the change in the value of money through index numbers of prices.

Fourthly the quantity of each commodity selected is an important matter. Different persons purchase different quantities of different commodities and services. Consequently the incidence of change in the general index number of prices or the value of money upon different persons depends on the relative importance of different commodities and their quantities which different persons consume and changes in prices of those different commodities and services. In case changes in prices of the different commodities are of a compensating nature, we may find that there is no change in the index number of prices or the value of money, yet the material welfare of different persons may be affected differently. For example suppose the prices of beef, mutton, etc. fall, but the prices of vegetables, milk, etc. rise in such a way that they compensate the fall in prices of beef, mutton, etc.; we may find that there is no change in the index number of prices or the value of money. But these changes are sure to affect adversely the persons whose greater portion of income is spent over purchasing those commodities whose prices have risen and favourably those persons whose greater portion of income is spent on purchasing the commodities whose prices have fallen.

Further it should be noted that the importance of different

commodities in consumption also varies from time to time. Commodities of great significance in consumption at one time may lose their importance or cease to be consumed at another time. Fifthly very often it is difficult to record prices accurately. Even if it be possible, sometimes changes in wholesale prices, which are commonly used for preparing the index numbers of prices, are not followed by changes in the retail prices, with which the general public is most concerned or which affect the value of their money most. In view of the preceding arguments it can easily be concluded that index numbers of prices are not an absolutely correct measure of changes in the value of money of any country, yet for general purposes they can profitably be employed as a rough measure.

Quantity Theory

We have already studied the procedure of calculating changes in the value of money and the method of expressing its value. Now let us examine the conditions on which the value of money depends. The value of every transferable or vendible commodity of the world depends upon the supply and demand of that commodity at a certain time. Similarly the value of money also depends upon its supply and demand. In simple words the supply of money in a country means all that money of the country which is available for being used to purchase other commodities of that country. This means the total stock of money of the country minus that portion which people have kept in hoards and which would not come out to the market to purchase other commodities. Countries where there is gold standard the total supply of money means the total quantity of gold coined and uncoined and even that portion of gold jewellery which in case of a rise of the value of money will be available for purposes of coinage or being used as money. On the other hand in India the supply of money does not mean the total stock of silver or gold of the country. In India conditions are quite different. In India coinage of either silver or gold is not free. India's standard is neither a true gold nor a true silver standard. In India there is no free coinage and both making and melting of

coins is unlawful. Here neither a stock of silver bullion can be converted into rupees or money nor rupees or other coins can be converted into bullion. Consequently the stock of metallic money in India is something rigidly fixed. Thus the supply of unlimited legal tender metallic money in India means only coined Rupees and Half-rupees which are available for purposes of exchange or making purchases of other commodities and services. Of course out of this stock of rupees in India we will have to exclude those rupees which are buried under ground or are kept in hoards or have been converted into jewellery and which are not available to the market for being used as a medium of exchange. Let us suppose for this supply of metallic money in a country at any time a symbol M .

The demand of money in a country is determined by the total of all commodities and services that are produced in that country minus those quantities of these commodities which are either directly consumed by the producers or are exchanged for other commodities under the barter system and do not exchange for money. In India as well as other countries of the world a big portion of services and commodities produced by agriculturists, small industrialists, and other people is consumed by them directly. That does not come to the market for being exchanged against money. In India agriculturists generally hold back a good part of their produce for their own consumption and do not bring it to the market for being sold against money. Moreover a portion of their harvest they give to the various classes of workers in payment of the different kinds of services performed by them in connection with the cultivation carried on by the agriculturists. Thus this portion also of agricultural products of this country does not make any demand on money. Similarly the cottage workers of India for example the weavers, blacksmiths, carpenters etc., and even some of the big industrialists consume some portion of their products directly and do not bring it to the market for being exchanged against money. Thus this portion of industrial products as well does not make any demand for money.

Many services in India as well as other countries are either consumed directly and are not paid for at all, or are paid for in the form of other goods and services and not in money. For example services rendered to self like shaving, washing etc., or to the family like cooking and household management by housewives are not paid for at all. Further in Indian villages it is a common practice to pay the domestic servants, sweepers, washer-men, weavers, carpenters etc. in grain when the harvest is reaped and not to pay them in money. Thus out of the total production of a country these services as well as commodities given if any, in payment of these services should be excluded from their total in order to form a suitable estimate of the demand for money in that country. In India some of the commodities are also exchanged directly *i.e.* commodity for commodity or the barter system of exchange. Therefore they also do not make any demand for money. Thus in a country the total demand for money means the total production of commodities and services minus that portion which is directly consumed and the portion which exchanges under the barter system rather than through the medium of money. Let us suppose for this net balance of commodities and services which gives us some idea of the total demand for money in a country at any time a symbol T .

Now we see that in simple words the value of money in a country depends upon its supply and demand or the relation of the total amount of available money with the net balance of goods and services available for exchange. We have already supposed that the above total stock or supply of money is represented by the symbol M and the total supply of commodities or the demand for money is represented by T . Thus the value of money at a certain time will be $\frac{M}{1}$ or the price of one unit of general commodities, or $\frac{T}{M}$ the value of one unit of money in terms of general commodities.

Further we should note that in a country it is not only metallic currency that exchanges for goods. Almost all the civilized countries of the world now make use of plenty of

paper currency or notes issued by the Government or Central Bank as well as the credit instruments such as cheques, bills of exchange and hundies. These credit instruments act as money and exchange for goods. They increase the volume or the supply of active money of a country which exchanges against goods. Thus the supply of money in a country means both metallic currency and all kinds of credit instruments. For all these credit instruments let us suppose the symbol M' . Thus the total supply of money of a country means $M + M'$.

Further we see that both metallic currency and credit instruments exchange for goods not only once but several times. The same unit of money or cheque may exchange for goods several times. A person with one rupee in his possession may purchase sugar with it. The sugar dealer with the same rupee may purchase rice and the grain merchant may purchase cloth with the rupee thus obtained, and in this way a rupee or credit instrument may go on circulating from hand to hand. This circulation of both the metallic currency and credit instruments increases the volume of working money of a country which exchanges against goods, though it does not increase the total quantity of actual money of the country. For these circulations of metallic money and credit instruments or their velocity let us suppose the symbols V and V' respectively. Thus the total supply of working money in a country at any time means $MV + M'V'$.

As with money so also with goods we see that some goods pass from hand to hand several times without being consumed. Consequently the same goods exchange for money several times before they are finally consumed. In doing so these goods require money several times in order to exchange against them and thereby they increase the demand for money. For this circulation of goods from hand to hand several times or their velocity let us suppose a symbol V'' . Thus we see that in a country at any time total supply of working money can be represented by $MV + M'V'$ and the total demand for money can be represented by TV'' .

Now the value of money in a country depends upon the

form of the preceding equation of exchange it was later on elaborated by Prof Irving Fisher the greatest advocate of the Quantity Theory of the Value of Money. It should be noted here that the Quantity Theory is not an absolutely exact explanation of changes in the value of money or the general price level. Prof Fisher has himself admitted that the relation between the quantity of money and the price-level does not hold good during the transition periods¹. The theory states that other things remaining the same, the value of money or the general level of prices depends upon the quantity of money in circulation. We know very well that in actual life other things do not remain the same. Even production of commodities and services is sometimes larger and sometimes smaller and bears no or little relation with the quantity of money in circulation. Consequently general prices fall or rise or the value of money changes when there might have been absolutely no change in the quantity of money. Prices may also rise and fall due to changes in the cost of production, tariff policy, establishment of monopolies or state control and may have nothing or little to do with changes in the quantity of money. In view of all these arguments it can be stated that like other laws of Economics, the Quantity Theory of Money as well is merely indicative of a tendency and not a conclusive cause of fluctuations in the general price level at all times.

Questions

1. What is meant by the term 'Value of Money'? What relation is there between the value of money and general level of prices? Explain.
2. What do you understand by index numbers of prices? How are they prepared? Explain by means of an example.
3. What difficulties are generally experienced in constructing correct index numbers of prices? Describe briefly.
4. How far are index numbers of prices a correct measure of changes in the value of money? Explain.
5. State and explain the Quantity Theory of Money and indicate its limitations.

¹The Purchasing Power of Money, pages 149-150

6. "The value of money depends upon its quantity." Comment on the statement.

7. "Like all other commodities the value of money as well depends upon its supply and demand." Explain the truth of this statement.

8. Other things remaining the same, what would be the effect of the following, according to Quantity Theory of Money, upon the value of money or the general level of prices of a country :—

(a) an increase in the circulation of notes, and (b) a development of deposit banking

9. Trace the relation, if any, between the use of cheques in a country and the value of its money.

10. Explain the following as clearly as you can :— $\frac{MV + M'V'}{TV} = P$.

CHAPTER XII

CREDIT

Definition. The inconvenience of a direct exchange of one commodity for another leads to the use of money. Similarly the inconvenience of having to pay for immediately a thing is purchased leads to trusting or credit. The word 'credit' is derived from the latin word 'credere', which means 'to believe'. Thus the word 'credit' implies belief or confidence of one person in another. This belief or confidence is the essential idea of all credit transactions and there are always two aspects of this confidence. One of them is the amount or value involved in credit and the other is the time for which a credit is granted. Thus in every credit transaction the confidence of the creditor i.e. the person who gives credit in the debtor i.e. the person who takes credit implies two limits. One of them is the value or the amount and the other is the time. Upto what amount and upto what time the creditor has shown confidence in the debtor are expressed in every credit transaction. Generally a person can have confidence in another man only upto a certain amount and for a certain time. For these reasons sometimes credit means the amount advanced and sometimes the time for which a credit is granted, but it must be noted that both these factors i.e., amount and time are present in every credit transaction. When a

person wants to express the amount upto which his creditor has reposed confidence in him, he uses the word credit with the particular amount such as X, Y, Bank has granted to P a credit of Rs 50,000/-. On the other hand if the idea is to express the time for which the creditor has reposed confidence in the debtor, the word is used with the particular period of time e.g., X, Y, Bank has granted to P a credit of six months. But it must be noted here that the amount and time are always combined in every credit transaction. No credit transaction can take place without both of them, though in naming it only amount or time or both may be mentioned as circumstances demand.

We have seen that the essential ideas of credit are its value and time. Hence credit may be defined as the transfer of any form of wealth from one person to another for a temporary period of time with a condition that its value will be given back by the receiver to the giver after the stipulated period. From this definition it is clear that the form of wealth transferred may be goods or money. Goods are said to have been sold on credit when the seller allows the buyer not to pay for them at once but after sometime. In the same way a person may give cash to another on the latter's promise that the money so received shall be paid back to the former after sometime. In some cases cash lent out is paid back after some time in goods or services. Thus the operation of credit may take any one of the above forms i.e., it may be goods or services for money; money for money, or money for goods or services. Therefore we see that the essential idea of credit is not the form of wealth that exchanges but the postponement of payment due for sometime long or short. Thus credit is protracted exchange and involves either the transfer of money or those forms of commodities and services whose value can be expressed in terms of money. For this reason we see that apparently whatever be the medium of giving credit whether goods, money or services, what is really transferred for a temporary period of time is some or the other form of wealth. A credit transaction therefore may take any one of the following forms:—

1. Cash against cash,
2. Goods against cash,
3. Services against cash,
4. Cash against goods,
5. Services against goods,
6. Goods against goods,
7. Cash against services,
8. Goods against services, and
9. Services against services.

Origin and Development. So long as society was so organised that people produced all that they consumed and consumed only what they produced, people rarely had any form of surplus wealth, and as such there was no question of immediate exchange, protracted exchange or credit. Credit originated only when people assumed division of labour and specialised in the production of only those commodities in which they found themselves possessing a comparatively superior ability. This specialisation led to the exchange of various commodities, because people began to produce not only with a view to consume all that they produced; but to exchange their surplus produce with the produce of others. So long as people's surpluses were just sufficient to enable them to obtain in exchange other commodities that they desired to consume there could not be any credit.

In course of time production intensified and people began to produce more than what they could consume either directly or by exchanging their surplus with the surplus commodities of others. This led to real surpluses or savings, *i.e.* stocks of commodities or wealth which were not required by their holders for immediate consumption. These stocks formed the basis of development of credit and when some people felt the shortage of certain commodities that they wanted to consume, they desired to have them from those who held them in surplus with promise to return them back after an agreed time. Thus there came an opportunity when people could give credit and demand credit, yet credit could not develop so long as there had not developed confidence—confidence of the lender of a

commodity that he would get back its value from the debtor within the agreed time. This confidence grew with the proper organisation of society. This shows that credit originated with the saving of wealth by some, demand of that wealth by others, and confidence of those who lent in those who borrowed.

The above description shows that the essential features of credit are three *i.e.*, surplus wealth with certain individuals as the result of saving; shortage of wealth with others due to temporary differences in their power of production and consumption, and the confidence of the former in the latter that the wealth lent would be received back within the agreed time. This shows that credit came into existence even before the introduction of money, but then it used to be given and taken only in the form of commodities. In such circumstances a person in order to obtain credit in the form of a particular commodity was not only required to find out a man who had any form of surplus wealth; but one who had surplus wealth in the form of that particular commodity which he desired to have on credit; and in addition to this he wanted a man, who could have confidence in him. Thus we see that in those days credit could be given by one person to another only when he possessed the following three qualifications :—

- (1) surplus wealth as the result of saving,
- (2) surplus wealth in the form of that particular commodity which a borrower desired to have, and
- (3) confidence of the person who could give credit in the person who desired to get credit.

With the introduction of the use of money in society the second qualification became unnecessary. When money came into use, which had the general power of purchasing all other commodities, the development of credit required only two qualifications, *i.e.*, the 1st and 3rd or the surplus money and confidence. Consequently credit began to develop fast, but so long as specialised production and trade did not develop sufficiently, people generally borrowed to overcome the difficulty of temporary shortages of their income in order to

consume all that they desired. Thus generally credit was given to consumers for purposes of consumption, but as the power of consumption of an individual depends upon his average income which is generally limited, the development of credit at this stage was also a very restricted one. The amounts of credit that used to be given were small and their periods short. Later on when production and trade developed on a large scale, people began to lend and borrow for purposes of production, and this led to a greater development of credit. Large sums of surplus money of others began to be borrowed and used in the further production of wealth; but so long as credits were given by individuals to individuals whose lives were limited and short, they were generally for short periods of time. With the development of partnerships and joint stock companies which have longer lives, credits began to be given and taken for long periods of time or for even indefinite periods of time such as the present day redeemable and irredeemable debentures of joint stock companies and other corporate bodies.

So long as society was not well organised and properly administered, confidence depended only upon the personal relations of the lender and the borrower and not upon the legal protection given to the creditor through written agreements and law courts. Consequently credit did not develop much due to lack of confidence; but as soon as law courts were established and definite laws were made to define and govern the relations of the lender and the borrower whether they were oral or in writing, credit developed very rapidly. But the development of credit at this stage was only local or national, and in every country depended upon the form of government and laws of that country.

In course of time the development of international trade and commerce and international institutions such as various exchange banks, the bank of International Settlements and the League of Nations led to the development of international credit. Huge credits were granted and received by the different countries of the world during the Great War of 1914-18 and

during the economic crisis of 1929—32. Even during the present world war huge credits have been and are being granted by one country to the other. It is worth noting here that before the Great War of 1914-18 there was not such a great development of international credit as it became after it. This is due to the fact that by the establishment of League of Nations after the Great War international relations became closer and better defined. Moreover the Bank of International Settlements, Geneva, established after the Great War largely facilitated the machinery of giving and taking international loans, and all this led to a greater development of international credit than before. At present in almost all the important countries of the world national credit is developed on a very large scale, but as yet international credit, inspite of the above encouragements, has not developed sufficiently. With a proper development of the powers of the League of Nations and the establishment of an International Court of Judicature or any other institution capable of enforcing international laws it is hoped that international credit will also develop on a large scale than at present.

Kinds of Credit

Producer's and Consumer's Credits. When credit is given to a person who makes use of it in the further production of wealth the credit is said to be the producer's credit. On the other hand if the borrower does not make use of the credit advanced in the further production of wealth, but consumes it in order to meet a temporary shortage of his purchasing power with the hope that in future he will be able to return the credit advanced out of the savings from his income or from his property, the credit is said to be the consumer's credit. Consumer's credit benefits only two individuals i.e., the borrower in the sense that he is able to overcome his temporary deficit and the lender in the sense that he is able to earn some money as interest. This form of credit does not benefit the society as a whole. On the other hand the credit given to producers does not only benefit the parties directly concerned i.e. the lender and the borrower, but the

society as a whole.

When credit is given to a producer he makes use of it in a more productive way than it could be used by the lender. The credit taken is used in some trade, industry or agriculture and thereby more of goods are produced. This enables the lender to get some interest, the borrower to get some profit, and the general public to get cheaper goods. Thus a person who takes a producer's credit in addition to the benefit to himself and the lender benefits his countrymen as a whole. Consequently the development of producers' credit in a country should be encouraged both by its people and the state by providing all possible facilities. Other things remaining the same the greater is the development of this kind of credit in a country, the higher will be its commercial, industrial and agricultural development and as such larger material welfare to the people.

Consumers' credit should be discouraged for it does not add much to the benefit of the society. This however, does not mean that in any country consumers' credits should not at all be granted. This will be positively harmful both to individuals i.e., the borrower and the lender and the country as a whole. Timely credit to a person who per chance has a temporary shortage of income gives him immense relief and saves him from disposing off some of his valuable assets under pressure. On the other hand loans freely given to imprudent and spend-thrift persons harm them as well as the society indirectly. As compared to other advanced countries of the world in India producers' credits are not sufficiently developed, but on account of expensive social customs there are plenty of consumers' credits. This is to some extent responsible for the industrial and commercial backwardness of this country.

From another point of view credit may be divided into four kinds:—(1) Cash Credit; (2) Book Credit; (3) Acceptance Credit; and (4) Commodity Credit.

(1) Cash Credit. When credit is given by one person to another in the form of money or cash, it is said to be a 'cash credit.' In Indian banking circles cash credit has a

technical meaning Here cash credit is an advance given by a bank against a promissory note signed by the borrower and another approved party and generally secured by the hypothecation of self liquidating stocks. The customer can either draw or repay in whole or in part the amount advanced at any time to suit his convenience. The accredited party pays interest only on the amount actually drawn. It is calculated on the debit balance at the close of each business day and not upon the whole amount of the loan. Interest is usually charged on the maximum daily balance at 1% above the bank rate. In India in the absence of bills of exchange being commonly used, cash credits are very popular. They are advantageous to the borrowers as well as to the lending banks. The borrower has the advantage of paying interest only on the portion of the cash credit actually used and reducing his obligation at any time according to his convenience. On the other hand the lending bank has the advantage that if the financial position of the borrower goes down it can curtail or withdraw the credit granted at any time. It should be noted here that in granting cash credits the lending bank's cash reserve is reduced as such its lending capacity is proportionately curtailed.

(2) Book or Open Credit. These credits are of recent origin and are generally granted by banks to their respectable and trustworthy customers or other persons on the guarantee of another reliable customer or on the basis of some suitable security. In this form of credit the lending bank does not give cash to the borrower as soon as the credit is granted. The borrower is permitted by the lending bank to draw cheques or bills up to the amount of credit granted and the bank honours these documents when they are presented. These credits are also commonly known as bankers' overdrafts. Here the borrower pays interest to the bank at the agreed rate from the date that the credit is granted, whether he makes use of it or not. As compared to cash credit here the borrower has the advantage that once the credit has been granted to him the banker can not cancel it without giving to the customer a previous notice.

of a reasonable period of time, and even after the credit granted has been cancelled the bank is bound to honour all such cheques of the borrower that were drawn by him before he actually received the above notice cancelling the credit granted. In England Cash Credits are not common, but bank over-drafts are very popular. Bankers' over-drafts are very advantageous to them for they entitle the bankers to charge interest from the very date that an over-draft is granted.

(3). *Acceptance Credit.* This form of credit is also comparatively of recent origin, and is very popular in countries like U. S. A., U. K., etc. U. S. A. has developed the system of banker's acceptances on a large scale only after 1913. In India banker's acceptances are not common. In this system of credit the accommodating banker neither lends cash nor reserves any portion thereof in order to meet the cheques or bills drawn by the borrower. Here a banker merely lends his name. The party desiring accommodation is permitted by the bank to draw on it a bill of exchange not exceeding the amount of credit granted. The banker accepts the bill and returns it to the customer. Now the customer can transfer the bill to any other person in payment of goods purchased or if he so desires he can discount it at any other bank and obtain cash. Before the bill becomes due the customer accommodated pays its amount to the bank and the bank on its turn meets the bill when it is presented to it on the due date.

In this way by means of a banker's acceptance a bank helps a customer without reserving or parting with any amount of its cash, and for this service a bank charges a small commission. It should be noted here that this form of credit is superior to both cash and book credits. It is advantageous to the accredited party in the sense that except a small commission it is not required to pay any interest to the bank. On the other hand it is advantageous to the accommodating bank in the sense that it earns a commission on taking only a small risk. As already mentioned above the bank merely lends its name and not

cash, and as such by granting a banker's acceptance the lending capacity of the bank is not at all reduced. The use of banker's acceptances rather enhances the lending capacity of a bank. Provided the customers are reliable, the bank can go on accepting hundreds and thousands of bills of the customers.

Commodity Credit. In this, credit is given by one person to another in the form of goods or commodities. These credits are commonly granted by big traders to retailers. Goods are sold on condition that the purchaser will pay the amount on the expiry of a certain period. In India in certain trades it is a common practice to allow the purchaser a credit period of 45 days to pay for the goods purchased and this time is commonly known as *Chut* ५२ . In this form of credit generally interest is not charged separately. The prices charged for the goods sold include interest for the period that the credit is granted. If however, any person to whom goods were sold on credit pays the price earlier, he is allowed a deduction from the amount of credit and this is commonly known as 'cash discount.'

'This form of credit is now very popular in the commercial circles of almost all the important countries of the world. It is very advantageous to both the parties i.e. the debtors and the creditors. The debtor has the advantage that he is not required to pay for the goods purchased at once. As such, he is able to purchase and stock more goods than his working capital would otherwise permit. Sometimes the debtor is able to dispose off the goods purchased within the period of credit granted and pays the creditor after that. Thus he makes a profit by taking only a small risk and without investing any portion of his own capital. To the creditor this form of credit is advantageous for through it he is able to sell more goods and earn larger profit than otherwise would be possible for him, and provided the customers to whom goods are sold are reliable there is also no risk of loss.

In rural areas in India among the agriculturists this type of credit takes a special form. Cultivators commonly borrow from

Zamindars and indigenous bankers grain and corn both for purposes of seed and consumption on promise that they would give them back after the crops have been harvested. Generally the forms taken by these credits are *Savaya* or $1\frac{1}{4}$ times, *Deorha* or $1\frac{1}{2}$ times, *Doona* or 2 times, *Dhieya* or $2\frac{1}{2}$ times, etc. Whatever quantity of grain or corn is borrowed by a cultivator, he is required to give back after the harvest $1\frac{1}{4}$, $1\frac{1}{2}$, 2, or $2\frac{1}{2}$ times of that according to the custom of the locality and the nature of the crop. Thus no separate interest is charged. The additional grain given back by the borrower according to the above rates represents interest for the period of credit on the quantity of grain borrowed. These credits are not common in other important countries such as United Kingdom, U.S. A., Germany, France, Japan, etc.

From another point of view credit can be divided into three kinds:—(1) Commercial Credit, (2) Industrial Credit, and (3) Agricultural Credit.

(1) Commercial Credit. When credit is advanced to a trader it is said to be a 'commercial credit'. Generally these credits are given in the form of mercantile goods. (Refer to Short Term Credit page 208).

(2) Industrial Credit. When credit is advanced to a manufacturer, miner, etc., it is said to be an 'industrial credit'. Generally these credits are given in the form of cash or money. (Refer to Long Term Credit page 209).

(3) Agricultural Credit. When credit is advanced to agriculturists it is said to be an 'agricultural credit'. In India this credit is generally given in the form of commodities viz., seed, manure, etc., while in other countries of the world it is generally given in the form of cash or money. (Refer to Long Term Credit page 209).

From another point of view credits can be classified into two kinds:— (1) Secured Credits and (2) Unsecured, Clean or Personal Credits.

(1) Secured Credit. In this form of credit the borrower pledges with the creditor some form of his property movable

or immovable from which the creditor can realise the amount of credit advanced with interest in case the debtor fails to pay back according to his promise. The security may consist of movable or immovable property and the possession of the creditor over the property pledged may be legal or equitable. Under this system the development of credit is a restricted one, as borrowers are expected to own some property on the security of which they can obtain credit. Here the position of the creditor is comparatively safer, because in such cases he builds up his confidence in the repayment of the loan on the basis of two factors : e., general reputation of the borrower and the total value of the property given as security.

(2) Unsecured Clean or Personal Credit In this form of credit the borrower does not give any form of property as security to back up the loan. In this case the creditor builds up his confidence in the repaying ability of the debtor only on the basis of the latter's personal reputation or what is known as surety. This surety may be given by the borrower only or by some others as well who may desire that the borrower may be able to secure a credit. As compared to secured credit this method of advancing credits is more risky for the creditors but borrowers are able to secure credits under this system more easily. Consequently there is a greater development of credit under this system than under the system of secured credits.

From another point of view credit may be divided into two kinds :—(1) Investment or Entrepreneurial Credit and (2) Simple or Non-entrepreneurial Credit.

(1) Entrepreneurial Credit. In this form of credit some persons give to others their money or wealth to be used in a productive way and also take the risk of failure of the business. In case those who receive such credits are able to manage the affairs of the business successfully, both the class of persons : e., those who receive credit and those who give credit benefit ; but in case of failure of the enterprise those who give credit lose their wealth and those who receive credit lose the benefit of their labour and enterprise. This

class of credit is very popular these days and takes the form of various classes of shares of public and private joint stock companies such as ordinary, preference and deferred shares. Strictly speaking it is not credit but proprietorship.

(2) Simple or Non-entrepreneurial Credit. In this form of credit those who give credit do not take any risk of success or failure of the enterprise. They advance their money on the definite promise of the borrowers that their money is to be returned to them on the expiry of the stipulated period of time. This class of credits takes the form of various kinds of debentures of joint stock companies such as simple and mortgage debentures. The various classes of debenture holders do not take any entrepreneurial risk. They get interest and do not share the profits of the company. Their advances are repayable to them according to certain stipulations on which the company takes their money.

From another point of view credit may be divided into three kinds:—(1) Personal Credit, (2) Bank Credit, and (3) Public Credit.

(1) Personal Credit. This term means the amount up to which credit may be advanced to a certain trader, firm or company and is generally used in commercial circles to represent the limit up to which goods or cash credits can safely be advanced to the above persons. These limits serve as guide to other business-men and banks in dealing with these persons.

(2) Bank Credit. This phrase is used to represent the credit operations of banks. The total credit business of a bank both of receiving and giving credit is known as bank credit. This term has come into use with the development of partnership and joint stock banks. Sometimes this term is also used to represent the limit up to which a bank allows a customer to draw against an overdraft granted.

(3) Public Credit. Generally this term is used to represent the total amount of advances made by the people of a country to its government. In modern times mostly the governments of different countries of the world are democratic,

run their budget from year to year, and have no big reserve treasuries. Consequently for purposes of non-recurring expenditure both productive and unproductive they have to resort to borrowing from the public. The success or failure of such borrowings depends upon the political and economic stability of the government or the confidence of the people in the ability and disposition of their government to honour its engagements. Productive borrowings of governments ultimately give some relief to the people in taxation, while unproductive borrowings increase the burden of taxation on the people, and in case they are very heavy the coming generations of a country have to suffer for the benefits of their ancestors.

From another point of view credits may be divided into five kinds. This classification is with respect to time for which credits are granted:—(1) Demand or Call Credits, (2) Short Term Credits, (3) Intermediate Credits, (4) Long Term Credits, and (5) Irredeemable Credits.

(1) Demand or Call Credits. These are loans granted by modern commercial banks to bill brokers and stock dealers at a money market, and are repayable immediately the demand is made i.e. without any previous notice. Such loans are popular only in important financial centres or money markets.

(2) Short Term Credits. There are loans granted by commercial banks to bill-brokers and traders for periods ranging from overnight and day to day loans to loans granted for any period upto 6 months. Such transactions are commonly found in only big commercial cities like Bombay, Calcutta, Cawnpore, etc. Governments also sometimes take such loans in order to meet the difficulties of the delay in the collection of their revenue. In India the Government of India issues Treasury Bills for periods of 3 months, 6 months and 12 months, and their use in this country is very popular.

(3) Intermediate Credits. These are loans granted to traders and agriculturists to tide over the temporary deficiencies or shortages of their working capital. They are

companies like the railway companies, tramway companies, etc., incorporated under special charters, are examples of credits of this kind.

Questions

1. What is credit? Give a suitable definition and explain the main elements which form the basis of all credit transactions.
2. Trace the origin and development of credit and point out the main factors which led to its very rapid development in modern times.
3. Distinguish between Producer's and Consumer's Credits. Which are better from the national point of view of a country? Explain.
4. What is the difference between Cash Credits and Bank Overdrafts? Explain fully.
5. What is Acceptance Credit? How does it differ from a Book Credit? Explain.
6. What is a Commodity Credit? How does it differ from Cash Credit? Describe.
7. Write short notes on :—
 - (a) Secured Credit,
 - (b) Entrepreneurial Credit,
 - (c) Public Credit, and
 - (d) Demand Credit.
8. Give a suitable classification of credits from the point of view of periods of credit and explain them briefly.

CHAPTER XII

CONDITIONS OF CREDIT DEVELOPMENT

We have already studied before that the basic principles of credit development are two :—

- I. The Demand of Credit, and
- II. The Supply of Credit :—

- (a) Ability to give credit, and
- (b) Willingness to give credit.

I. *Demand of Credit.* Credit may be demanded for purposes of production or consumption. For purposes of consumption credit can be demanded only to a limited extent, and at any time would depend upon the total amount of shortage that the people have in balancing their income and expenditure, and the amount of savings that they expect to

be able to make out of their future earnings, which they can use in paying back the credits received. Thus the two limiting factors for the development of consumers' credit are : (1) the total amount of shortage that the people have in their family budgets and (2) the total amount that they expect to save out of their future earnings. For men in general both of these amounts have more or less inelastic limits and as such the development of consumers' credit remains only a restricted and limited one.

With the development of trade and industry people begin to demand credit for productive purposes. Persons who have no capital of their own or an insufficient one, but are able to carry on trade and industry successfully and profitably begin to borrow from others, and the more they are able to get and invest in their business the greater is the amount of profit which they are able to earn for themselves. The total amount of capital that an entrepreneur can make use of in his business depends upon the entrepreneurial capacity of the individual and the nature and method of production of his business. As these limits are sufficiently elastic and trade and industry continually try to develop, for productive purposes there is continually a larger and larger demand of credit; and the more it is possible for the entrepreneurs to get cheap credit as working capital, the greater is the development of trade and industries. Thus we see that the development of business and credit is inter-dependent, and unless checked by other factors both of them go on increasing by reacting upon each other. In almost all the advanced countries of the world such as U.S.A., U.K., Germany and Japan ; the development of credit today is much larger than before the industrial and commercial revolutions or a few hundred years back. In India also the development of credit today is much larger than it was before the development of trade and industries on large scales.

II. *Supply of Credit.* Now let us examine the other factor that determines the development of credit i.e., the supply of credit. The supply of credit depends upon two factors :—

(a) the ability to give credit and (b) the willingness to give credit. The ability to give credit depends upon the amount of surplus wealth that can be given on credit and an effective machinery to bring that surplus wealth from the hands of those who have it and offer it to those who demand credit. Surplus wealth depends upon the income and expenditure or the production and consumption of the people of a country in general. Times when trade and industry are brisk and country as a whole produces more than it consumes people make savings and these savings go to form the surplus lendable wealth which can be used in giving credit. Thus in a country ability to give credit depends upon the existing stock of wealth and the annual additions made to it during periods of prosperity. On the other hand in periods of depression incomes of the people in general fall short of their expenditure and there comes a drain on the existing wealth with the result that the lendable capital or ability to give credit goes on decreasing.

Before the present world war broke out the total existing wealth of India was estimated at Rs 15 500 crores, or Rs 443 per head of population and the total yearly income at Rs 2 500 crores or Rs 71 per head of population. In other advanced countries of the world the above per capita figures were USA Rs 9 365 and Rs 2,053 United Kingdom Rs 6 371 and Rs 1 092 Canada Rs 8 023 and Rs 1 258 France Rs 4 681 and Rs 636 and Japan Rs 2 308 and Rs 271 respectively. The above figures show that as compared to other advanced countries of the world both the existing wealth and yearly income per head of population in India are very low and as such India as a whole has a very small capacity of giving credit.

The other factor that determines the ability to give credit depends upon that effective machinery which tries to extract wealth from those who have a surplus of that and place it at the disposal of those who require it. This machinery is the development of banking. Greater is the development of banking in a country the more effective is the machinery

for improving that country's ability to give credit. The working of this machinery is very much facilitated by the use of suitable credit instruments.

The use of credit instruments brings about the development of credit by adding to the confidence of those who supply credit and fixing the nature of responsibility of those who demand it. If credit in any transaction is supported by the use of a recognised credit instrument both the debtor and creditor know the exact nature of their powers and responsibilities and have not to depend upon some unknown, undefined, or uncertain customs or circumstances. We should note here that none of the preceding factors which contribute to the development of credit *i.e.*, the development of trade and industries, the development of ability to give credit by increasing surplus wealth and the development of banking, can develop credit in a country unless those who have surplus wealth are willing to give it to others. This willingness to give credit to others depends very much upon the confidence of creditors into the ways and means of getting back the credits given or advances made.

Unless a person has confidence that he will get back what he lends according to the terms of the transaction, he would not like to advance his surplus wealth to others. This confidence of the people in general depends upon a sense of business morality; recognition of the principle of private ownership of wealth; sanctity of agreements of payment, strength of the government of the country *i.e.*, freedom from external and internal troubles; laws and law courts clearly defining the rights of debtors and creditors and helping the people in the enforcement of these rights; the standards of literacy of the people; and their acquaintance with the modern ways and means of giving and receiving credits.

We see that as compared to a few hundred years back credit in India today is highly developed. The present day volume of credit in India is several times of what it was during the times of Muslim rule in India, and the main reasons which have brought about this rapid development of credit in India

are some of those mentioned above. The establishment of British rule in India has brought a rapid development of confidence and this coupled with the development of joint stock banking has resulted in the rapid development of credit though as yet compared to other advanced countries of the world such as U.S.A., United Kingdom, France, Germany and Japan, the development of credit in India is small.

Advantages of Credit

The development of credit brings with it numerous advantages both to the individuals and to the society. Let us now examine some of the important advantages of the development of credit:—

(1) Credit enables individuals and institutions like joint stock companies, partnership firms, trust bodies, etc., to tide over their temporary deficiencies of income in order to meet certain pressing emergencies of expenditure. At such times if credits are not available these persons will be forced to dispose off some of their valuable assets in order to obtain funds to spend them to purchase the commodities that they desire. This forced sale may bring them a great loss.

(2) Secondly the development of credit enables those who have any surplus wealth to lend it to those who require it in order to earn something as interest. If credit is not developed, a good deal of such surplus wealth will remain idle and people will not have much incentive to save, because men by nature generally give more importance to their present wants rather than their future needs. For this reason a good deal of capital of those men who can not make any productive use of it because they are either incapable or unwilling to do so, shall remain either idle or be spent up in satisfying unnecessary or undesirable wants and thus be wasted.

Population is continually growing and an increasing population should have increased production, which its standard of living may improve or remain at least the same. Increasing production besides other things requires larger and larger amounts of capital. Thus saving something out of the present

income is necessary for every generation. We see that if credit is not developed this saving will be discouraged. Consequently newer generations will not start with any increased amount of capital, and as such production and with it the standard of living will continually fall and bring with it distress and misery.

(3) The development of credit or ability to borrow enables a person who has no capital or insufficient capital of his own to do business and earn a decent living for himself by borrowing capital from others and doing business with the help of that. Thus with the development of credit, trade and industry are not the monopolised occupations of the few rich and wealthy only. It is now possible for a person, who has not sufficient capital of his own, but has sufficient entrepreneurial ability, to carry on a trade or industry by borrowing capital from others.

(4) Ability to borrow whenever a person likes to do so and return the credit received whenever convenient has made it possible for a businessman to adjust his working capital at different times according to the varying needs of his business. In brisk seasons when he finds that his working capital is not sufficient he can borrow capital from others, and in dull seasons when he finds that he can not make good use of a big working capital he can easily withdraw some of it from his business and return it to those from whom he took it. Thus neither in busy and brisk seasons he has to suffer for want of capital, nor in periods of depression or dull trade he is compelled to keep a big working capital locked up in his business in a less productive form. This factor of credit is of very great importance in specially those industries and trades whose working is seasonal such as sugar, ice, cotton ginning, etc. Marketing of agricultural products in India is also a seasonal trade and those who carry it on need a large amount of capital for financing it when the crops are harvested. but as soon as this busy season is over a good deal of their working capital becomes released to be returned to the creditors or invested somewhere else. Due to insufficient

development of credit people who carry on this business as well as the agriculturists suffer in this country.

(5) When credit is developed in a country exchange of goods takes place both against money and credit. A good deal of commodities is purchased against credit instruments and these instruments in course of time are cancelled against each other. For example A purchases some goods from B against a bill of exchange. B endorses the same bill to C against purchase of some goods and C endorses it back to A against the purchase of some goods in whose hands the bill automatically cancels itself. Thus we see that goods exchange at three places without the use of money. In this way the development of credit economises the use of metallic money and the national wastage due to wear and tear of metallic currency is saved.

(6) The development of credit enables the metallic currency of a country to meet the growing requirements of trade and industry. As a result of commercial and industrial revolutions there is now continually an ever increasing production of goods in almost all the countries of the world. These goods come into the market for purposes of exchange, and as money is the medium of exchange they generally exchange through that medium. In case credit in a country is not developed and all work of exchange has to be done only through the medium of metallic money, the general price level will remain low and go on decreasing as more of goods will have to exchange for the same quantity of money. The result will be that the prices will remain unnecessarily low and production will suffer. Thus the development of credit in the form of paper currency and credit instruments increases the volume of money and stabilises the general level of prices.

In India when the agricultural crops are harvested in the months of March and April there is a great demand of money in order to finance the marketing of these products. The total amount of metallic and paper currency is not able to meet the demand of money and generally there is a stringency in the money market in that season.

Consequently prices of agricultural products remain low and traders and agriculturists thereby suffer. This is due to the fact that credit in India is not sufficiently developed and the total volume of metallic currency, paper currency and credit is not able to adjust itself to the varying needs of money in the market. On the other hand in dull seasons there is a great volume of surplus currency in the market. This is commonly known as inelasticity of the Indian money-market and it can be removed by a temporary increase in the paper currency through expansion of credit. The increased credit of the brisk season will cancel itself automatically in the dull season. Thus the total volume of medium of exchange will be elastic or adjustable to its varying requirements in the market. It will expand in brisk seasons and contract in dull seasons, and as such prices on the whole will remain more or less the same at different seasons and the producers will not suffer unnecessarily. Thus we see that the development of credit can enable the metallic currency of a country to meet the ever increasing and varying requirements of her trade and industry. It should however be noted here that an unnecessary expansion of credit in a country may promote imprudent investment and unhealthy speculation, and as such the country may be subjected to a financial crisis.

(7) Another important advantage of the development of credit is that it makes it possible for a country to make a complete and most productive utilisation of its human and natural resources. We have already seen that if in a country credit is not developed a number of persons, who have no capital or insufficient capital but enough of entrepreneurial capacity, are not able to carry on business according to their capacity, *i.e.*, they are either compelled to carry on those businesses in which the amount of capital that they have suffices or carry on a business on a lower scale. In both of these cases it is obvious that their entrepreneurial capacity is not fully utilised or that it is not used in the most productive form, with the result that such persons

as well as the society suffers. On the other hand if credit is developed in a country, it is possible to utilise the capacities of these persons in the most productive form.

What is true in the case of persons is exactly true in the case of other natural resources of a country as well. If credit is not developed a number of natural resources of the country such as forests, mines, waterfalls etc., remain undeveloped or inadequately developed due to lack of capital. We see that it is not necessary that those who have the possession of these natural resources in any country may necessarily also have capital to work these resources to the best advantage. Moreover the working of some of these resources requires such a large amount of capital which cannot conveniently be contributed by one individual only. Some industries require huge amounts of capital. Consequently if credit is not developed industries like shipping, railway, telephone, telegraph, tramway, mining, etc., remain undeveloped in spite of the existence in the country of natural resources suitable for their development. Further the working of industries on a large scale requires huge amounts of capital which can not conveniently be contributed by one or two persons. If credit is not developed in a country, it shall not be possible to carry on industries on a large scale, and thereby the country shall lose the immense advantages of large scale production. Thus we see that the development of credit in a country makes it possible for that country to make a most productive utilisation of its human and natural resources. It is possible thereby to organise industries on large scales and to increase the efficiency of labour and capital by enabling them to work in those industries where they give the maximum return.

(8) Development of credit enables the government of a country to obtain funds for productive and unproductive, and recurring and non recurring expenses. Government borrowings are of two kinds :—(1) short term and (2) long term. Short term borrowings of the government, are made only to adjust the irregularities of collection of the government revenue, and

at the end of each financial year the government pays back almost all the short term borrowings made during that year. Long term loans of the government are taken for two purposes i.e. productive and unproductive purposes. Sometimes the government of a country needs a big sum of money in order to carry on a war to maintain the political freedom of the country or save the country from foreign aggression. In olden times when governments were monarchic, kings used to have big personal treasuries, but in modern times of democracy governments do not have any big reserve treasury, and therefore for all such emergent expenses there is the need of raising loans for long periods of time.

Further there is a large number of industries of public utility in whose case it is highly desirable that there should be a monopolistic organisation. Such industries can suitably be carried on by the State only e.g., Postal, Telephone and Telegraph industries. Moreover industries for which a good deal of land has to be acquired on cheap terms such as tramways, canals and railways are also suitable for State working. Sometimes an industry is new and the cost of making its experiment is very high, the risk is great, and therefore private enterprise does not come forward to take it up, such as aluminium industry in India sometime back. In order to start or carry on these industries the State requires huge amounts of capital. The development of credit enables the State to acquire this capital in order to carry on these industries, which in the absence of development of public credit either remain undeveloped or carried on in an inefficient manner. Thus we see that the development of credit is advantageous to the capitalists, labourers, traders, industrialists, consumers, and the society as a whole. Briefly speaking the better is the development of credit of a country, the greater is its economic advancement such as we find now in countries like U. S. A., United Kingdom, Germany, Japan, etc. But one thing which must be kept in view here is that the proper development of credit in a country presupposes the existence of a highly organised monetary system.

Credit and Capital

Does credit create wealth or capital? Some persons assert that credit creates wealth. There are others who say that credit does not create wealth but creates capital. There is a good deal of controversy about it. Let us now examine here briefly as to how far either of the assertions is true and correct. Credit is defined as the transfer of wealth from one person to another for a temporary period of time with a stipulation of its value being returned back. Thus credit presupposes the existence of wealth which is transferred. This transfer of wealth may be for a productive or unproductive purpose, i.e., the debtor may use the amount borrowed in some trade industry or other productive occupation, or may consume it in order to satisfy some of his wants. If the borrower uses the amount lent to him in some productive way, there is no doubt that that much of wealth transferred under that credit transaction becomes capital and in course of time creates additional wealth. Thus we see that all idle money borrowed for productive purposes creates capital directly and in case the industry in which it is used turns out to be successful it also indirectly creates wealth. On the other hand if credit is advanced for an unproductive purpose i.e. consumption, it brings some income to the creditor as interest and from his point of view it may be treated as capital, but from social or national point of view it is not capital. Thus such a credit creates neither capital nor wealth.

Many persons who assert that development of credit creates capital, assume that those who have surplus wealth do not make any productive use of that, and as such its transfer from those hands into hands where it is used in a productive way is really creation of capital. The above assumption could be true and have some force at a time when banking was not developed and people generally preserved their surplus wealth by burying it under-ground or by hoarding it in iron chests; but in modern times it is difficult to find men in general, who do not make any productive use of their surplus wealth. At present the fact is that those who have any surplus wealth do

make some productive use of that, though it may not be as productive a use as it may be possible for its borrowers to do. Thus in a country where credit is not at all developed it would be correct to say that its development has created capital, for it converts the existing idle wealth into productive capital. On the other in a country where credit is already developed, it would be incorrect to say that its further development has created any capital, though it would be correct to say that it has enhanced the productivity or efficiency of its capital. Thus in modern times in most of the countries further development of credit does not create capital, but enhances the efficiency of the existing capital. Indirectly the development of credit creates both additional wealth and capital, which are useful for the society or people of a country. As such development of credit in each country should be encouraged by all possible ways.

Questions

1. Describe briefly the factors which contribute to the development of credit in any country.
2. What are the advantages of the development of credit in any country? Describe briefly.
3. 'Credit creates capital.' Comment on this statement pointing out the extent upto which it is true.
4. What is the effect of the following on the credit development of a country :—
 - (a) Development of banking,
 - (b) Use of credit instruments, and
 - (c) Fall of general price level.
5. 'Development of credit is useful not only to persons directly concerned, but to the whole society.' Justify the truth of the statement.

CHAPTER XIV

CREDIT INSTRUMENTS

No discussion of credit and the various problems relating to it is complete without a reference to the various credit instruments. A credit instrument is a written agreement, which contains the various terms and conditions on which

a particular credit has been given or taken. These terms and conditions define the relation of the debtor and the creditor or their different rights and responsibilities. Many of the credit instruments are also transferable i.e., they can be transferred by their holders to other persons in payment of debts or other obligations. Thus when in any transaction a credit instrument is used, credit may not stop only at the place where it originated, but may circulate through that instrument from hand to hand till it is finally paid and cancelled. Thus the use of credit instruments encourages the development of credit in a country in two ways. Firstly they put the credits into a tangible form and fix the exact rights and responsibilities of the parties and thereby add to their confidence. Secondly they enable the credits to be transferred from one person to another according to the convenience of the parties. Both of these factors help the development of credit in a country very largely and as such the use of proper credit instruments should be encouraged in a country in all possible ways.

One way in which the use of credit instruments can be encouraged in a country is the making of statutory laws that would govern these documents. These laws should be definite and as far as possible uniform throughout the country. Bills of exchange, promissory notes, cheques and hundies are some of the credit instruments that are very commonly used in every commercial country. They are used in India as well, but for bills, notes and cheques in India there is the Indian Negotiable Instruments Act 1881 which clearly defines the rights and responsibilities of the parties connected with the use of these instruments. For hundies there is no codified law in this country. At present they are governed by different customs of the different localities and in case there is no definite custom with regard to any point of dispute connected with them it is decided according to the Indian Negotiable Instruments Act. It would be much better and encourage the use of hundies on a larger scale, if the law relating to them as well be codified and made uniform throughout the country. Moreover the use of credit

instruments should be encouraged by the State in other ways also. Exemption of cheques from stamp duty according to the recommendation of the Hilton Young Currency Commission 1926 was a very right way of encouraging the use of cheques in India by the Government. This should be continued and the use of *hundies* and other credit instruments also should be similarly encouraged by reducing their stamp duties and standardising their forms.

Specimen of a Cheque

B/28	B/28.
238/A44C06.	238/A44005.
1st December, 1944.	Lucknow, 1st December, 1944.
Bala Prasad & Sons., 25, Aminabad, Lucknow.	The Central Bank of India Ltd., Lucknow Branch.
In full settlement of account Rs. 460/8/-	Pay Messrs. Bala Prasad & Sons, or order Rupees Four Hundred and Sixty, Annas Eight only.
R. D. S.	Rs 460/8/- R. D. Sinha.

1. *Cheque*.—Cheque originated in England. Upto 1708 banks in England issued notes payable to bearer on demand, but the Act of that year forbade the issue of such notes. The London private bankers thus became incapable of competing with the state-protected Bank of England which had the monopoly of issuing notes in the metropolitan area. Hence compelled to find some means for retaining their business in face of the competition of the Bank of England, the private bankers resorted to a practice which later on developed into the modern cheque system. "The original form of the gold-smith's note had been a written request of the customer that the gold-smith should pay a certain sum out of the customer's money to a named payee. In July, 1729 printed forms for their notes were first issued by Messrs.

Child & Co. these forms being similar to the modern cheque in that spaces were left for the customer to fill in the name of the payee and the sum payable. The London bankers encouraged this practice as it enabled them to compete with the Bank of England, and, about 1780, discontinued the issue of notes in favour of the issue of these printed forms of cheques, by the use of which depositors could withdraw upon demand such amounts as they required, or by means of which they could instruct their bankers to make payments to third parties. The new system proved a complete success, and when a clause in the Bank Act of 1833 permitted the establishment in London of joint stock banks for all banking business except note issuing, a number of corporate banks were formed with the principal object of accepting deposits withdrawable on demand by cheque."¹

In India the cheque system came with the establishment of early European Agency Houses such as Messrs Alexander & Co., Fergusson & Co., etc. Most of these firms came into existence sometime in the middle of the eighteenth century. They were trading firms but for the benefit of their constituents they also combined the business of banking, and became the predecessors of early joint stock banks of India. They were already acquainted with the cheque system of English banks and introduced the same in this country. In India also upto 1861 banks were allowed to issue notes. Consequently upto that year the main business of joint stock banks was to issue notes, but when in that year the Government of India deprived them of this business, they began to specialise in deposit banking and cheque system. Later on the Indian joint stock banks formed mostly in the first decade of the 20th century also took up the business of deposit banking and cheque system, but owing to illiteracy and want of clearance facilities, the cheque system has not yet developed into this country sufficiently. Most of the payments in India today are made in legal tender, whereas in England the use of cheques is very popular. Recently some of the

¹ Banker & Customer by S. E. Thomas pages 6 & 7

Indian banks such as the Central Bank of India have begun to issue cheque forms in Indian languages. This is expected to make the use of cheques more common and help the development of credit into the country.

Legally a cheque is an instrument in writing, containing an unconditional order, drawn by a person upon his banker, signed by the maker, directing the bank to pay a certain sum of money only, to, or to the order of a certain person, or to the bearer of the instrument, and not expressed to be payable otherwise than on demand. From this definition it can be noticed that a cheque must be in writing; it is drawn by the customer of a bank who has money deposited in his account or has arranged for an overdraft from the bank; it is payable to bearer, self, or a certain person, or to the order of any one of these persons; and that it is expressed to be payable always on demand. Thus we see that a cheque is also transferable. In transferring or sending cheques to persons residing at a distance, there is the danger that a cheque may be lost and may come into the possession of a wrong person, and as such payment from the drawee bank may be obtained by that unlawful holder. To save a cheque from this danger it may be crossed.

Crossing of a cheque means drawing of two parallel lines across the face of a cheque, with or without mentioning the name of any bank in those lines of crossing. The former is said to be a *Specially Crossed Cheque*, while the latter is said to be an *Ordinarily Crossed Cheque*. Payment of a specially crossed cheque can be obtained from the drawee bank only by that bank, whose name is mentioned within the lines of crossing. On the other hand payment of an ordinarily crossed cheque can be obtained from the drawee bank by any bank collecting the cheque on behalf of the holder. Thus in all crossed cheques payment by the drawee banks is not made directly to the holders on their presentation at the counter, but to some particular or any other bank as required. This insures safety or correct payment of the crossed cheque to the right holder, for if a crossed cheque is collected by a bank for an unlawful holder,

the collecting banker becomes responsible for that to the paying banker. Thus a crossed cheque remains safe in transit. With the development of modern banking the use of cheques has become very popular. They have become a good substitute of legal tender money and thereby economise the use of it to a very great extent. Cheque is a negotiable instrument and in India it is governed by the Indian Negotiable Instruments Act 1881.

Specimen of a Bill of Exchange

No. 234.

Allahabad.

The 15th October, 1944.

Rs. 500/-.

Stamp.

As. 9.

Three months after date pay to us or order the sum of Rupees Five Hundred only, for value received.

For Sadan Lal & Sons.,
Yugal Kishore Khanna,
Managing Partner.

To

Messrs. Magin Bros.,
Mall Road
Cawnpore.

2. *Bill of Exchange.*—Bills of exchange are instruments comparatively of modern origin. According to C. J Cockburn they were first used by the Florentines in the twelfth and by the Venetians in the thirteenth century. Later on they found their way slowly into France and England. In India in their indigenous form known as *Hundi*, they are supposed to have existed even in early Hindu times. In their modern form they came into this country during the 18th century when several English, French, Dutch and Portuguese trading firms established their businesses at the various port towns of India. In other important countries of the world bills of exchange and promissory notes are popular. They are commonly used and are very convenient mediums of giving and taking commercial credits. In India their use is not very common.

as yet for the reason that people find *hundies* as good substitutes of these documents. *Hundies* are written in Indian vernaculars and most of the merchants of this country, being not educated in English, find it more convenient to use *hundies* rather than bills of exchange or promissory notes.

A bill of exchange is an unconditional order in writing, signed by the maker and directing a certain person to pay a certain sum of money only, to or to the order of a certain person, or to the bearer thereof. Thus we see that a bill of exchange is a good credit instrument. It puts a debt into a tangible form and fixes the date of its payment. It is also a transferable document, and the creditor or the holder, if he so likes, can transfer it to another person in settlement of his own account or to obtain cash before the instrument becomes due. A bill of exchange may be inland or foreign or payable to a certain person or to the bearer of the instrument. It is a good representative of money and easily transmissible. Thus it obviates the trouble and expense of transmitting coin or legal tender money, and its use on a large scale helps the development of credit in a country to a great extent. In India at present bills are used only in a few important commercial centres, where people have picked up western methods of business. In order to develop the credit system of this country the use of bills of exchange should be encouraged in all possible ways, and much in this direction can be done by the Reserve Bank, the Imperial Bank and other commercial banks of the country.

Specimen of a Promissory Note

Cawnpore,
10th May, 1944.

Rs. 900/-.

Stamp.

As. 15.

Three months after date I promise to pay the Kamla Woolen Mills Co., Ltd., Cawnpore, or order, the sum of Rupees Nine Hundred only, for value received.

Nand Ram,
General Merchant

3 *Promissory Note*—A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument. Thus a promissory note must be in writing and must contain an unconditional promise to pay a certain sum of money only to a certain person or to the bearer thereof. The promise to pay may be after a certain time or on demand but it must be noted that Section 22 of the Reserve Bank of India Act 1934 prohibits the issue of a demand promissory note payable to bearer by any other person except the Reserve Bank. In India the issue of such promissory notes is the exclusive monopoly of the Reserve Bank of India.

As bills of exchange so also the promissory notes come into use in India with the development of Indo-European trade and modern banking. Consequently the use of these notes is as yet limited only to a few important commercial centres and among business men who have adopted the western methods of business. Most of the other merchants of the country who do business on the indigenous style use *hundies* for their credit transactions. A promissory note may also be inland or foreign or payable to a certain person or bearer but as already pointed out before it can not be payable both to bearer and on demand. As it is a promise it does not require any acceptance like a bill. It is a negotiable instrument and can be transferred from one person to another in payment of debts or other obligations. Thus like bills of exchange their use also on a large scale develops credit in a country to a great extent. For this reason like bill the use of this instrument also should be encouraged in all possible ways. In Indian vernaculars a demand promissory note is said to be *Ruqqa Indul Talab* and along with its receipt is very commonly used by the indigenous bankers of this country in their money lending transactions. According to the Indian Limitation Act IX 1908 Article 59 a demand promissory note unless renewed remains enforceable for a period of only three years from the date of its making.

Specimen of a Form of Hundi

नम्बर

रुज

टिकट

॥ श्री ॥

सिद्ध श्री मुम्बई महा शुभस्थान भाई.....

जोग लिखी श्री हाथरस से चुन्नीलाल रतनलाल का.....वाचना
 उपराँच हुन्डी १ रु०.....अक्षरी रुपया.....का निमे रुपया
का दूना पूरा यहाँ राखे भाई.....

पास पुगे तुरत पीढ़े नामे साहजोग ठाव ठीकाणे घर चौकस करके रुपया हुन्डी
 चलन का देना ।

सं० मिति.....फा०

दस्तखत

English Translation

No.....

Presentation Date.

Shri,

Stamp.

To pleasant and prosperous town Bom-
 bay, the abode of merit therein to Bhai
 (brother).....written from Hathras
 by Chunni Lal Ratan Lal, whose greetings you be pleased to
 accept. Further a *hundi* is drawn for Rs.....in words
 Rupees.....twice of Rs.....the
 double of which, in favour of Bhai (brother).....
 Immediately on presentation of this *hundi*, you will please
 pay the amount thereof in current coin to the presenter, after
 ascertaining his respectability, title and address.

Samvata.....Date (Indian).....Date (English).....

Signature.....

4 *Hundi*—*Hundi* is a vernacular term and means an indigenous credit instrument of India. It is perhaps the oldest surviving form of a credit instrument of India. Usually a *hundi* is a written unconditional order though it may also be a conditional order, made by one person upon another for the payment of a certain sum of money on demand or after a specified time, to a certain person or to the bearer thereof. Thus a *hundi* may be a conditional or unconditional order and in this respect it differs from a bill of exchange. Further it may be payable on demand or after some specified time. It may be payable to bearer or order. A *hundi* is generally written in Muria or Hindi and takes the form of a letter rather than a formal business credit document. In India the use of *hundies* is very common specially among the indigenous bankers and traders who carry on business according to the old indigenous system. The Indian Negotiable Instruments Act 1881 does not govern the indigenous instruments like *hundies*. They are governed by custom. Consequently both their forms and rules that govern them vary from place to place. They are not standardised documents. The present case law on *hundies* is also extremely confusing. Modern joint stock banks still treat them as *partahs* and feel shy of dealing in them. Like bills and promissory notes, *hundies* also require stamp and are negotiable instruments. *Hundies* account for a good deal of development of commercial credit in India, but as they do not receive sufficient encouragement from the State or the modern joint stock banks their use is continually declining in face of the competition of modern bills of exchange and promissory notes.

Specimen of an I O U.

227, Conning Road,
Allahabad.

To

Messrs. Mohan & Madao,

August 25, 1944.

Jhonstonganj, Allahabad.

I owe you the sum of Rupees Five Hundred only.

For Kapoor Bros.,

L. P. Kapoor,

Rs 500/-.

Senior Partner.

5. *I O U.*—This means 'I owe you'. This is a document which acknowledges a debt. In this document the maker acknowledges that he owes a certain amount of money to another person whose name is written in the document, but for the repayment of it no time is fixed. This document is not transferable. It creates credit only between two parties i.e., the person in whose favour the document is made and the person who signs it. In this respect this document is different from a cheque, bill of exchange, promissory note or *hundi*. Thus with the use of I O U. credit development is only a restricted one, whereas with the use of other credit instruments it becomes extensive or circulatory. This document is used in a few commercial transactions between traders, but neither in India nor in other countries of the world its use is popular. It has greatly been substituted by modern bills of exchange, promissory notes, *hundies*, etc. As an I O U. is merely an acknowledgment of debt, it does not require any stamp.

6. *Government of India Promissory Notes.*—These are promissory notes which were issued by the Government of India in different years from 1842 to 1900. They are irredeemable i.e., they are repayable to the holders at the option of the Government after giving three months notice, and as such no time of repayment is fixed for them. The Government pays interest from 3 to $3\frac{1}{2}$ p. c., per annum to the holders of different notes. They are transferable. Consequently they are sold and purchased every day in the Indian Stock Exchanges of Calcutta and Bombay, and their quotations appear in the daily market reports that are published in the different news papers. The Government Promissory Notes are governed by the Indian Securities Act X 1910. It is difficult to say whether they are negotiable instruments within the meaning of the Indian Negotiable Instruments Act 1881, though the English Law would undoubtedly regard them as negotiable instruments. Interest on these notes is payable by the Government half-yearly, and they are not free from income-tax. They are transferable with the approval of the Government or the issuing authority. These notes had helped the Government to obtain funds for meeting certain

non recurring expenses and have not now been issued from a long time. They are a useful source for a permanent investment of money on moderate rates of interest, but the money gets locked up with the Government and is not available to the industrial and commercial class of men of the country. They help the development of credit of the country to a small extent.

7. Government Bonds—These are securities or certificates issued by the Government of India or Provincial Governments to the subscribers of various loans floated by them from time to time for productive and unproductive purposes. For convenience of accounting the values of these bonds are fixed at Rs. 100 each or amounts that are multiples of one hundred rupees. They carry interest at fixed rates and may be issued at a discount, a premium or at par. They are repayable at the end of certain fixed periods of time. The repayment may be made in whole or in instalments. The date or dates of repayment are mentioned in the bonds, for example Government of India 3 per cent 1946 Defence Bonds; $4\frac{1}{2}$ per cent. (1955-60) Bonds; 5 per cent. (1943-60) Bonds; $2\frac{3}{4}$ per cent (1945-52) Bonds, etc. If there is only one date mentioned such as 4 per cent 1945, it represents the year when the loan will be repaid by the Government in full in one instalment. On the other bond if two dates are mentioned such as $2\frac{3}{4}$ per cent. (1945-52), it means that the loan will not be paid back before 1945 or after 1952. Within these two dates on giving 3 months notice the loan would be paid back by the Government at any time either in one instalment or several instalments spread over from 1945 to 1952.

Interest on these bonds is paid by the Government at the fixed rates every half-year. Some of them are free from income-tax deduction while others are not. They are a good medium for both Central and Provincial Governments to obtain funds for non recurring expenditure. In the Indian Stock Exchanges of Bombay and Calcutta these bonds are sold and purchased every day, and their quotations appear in the different market reports. These documents can be transferred by

their holders to other persons with the approval of the Government or the issuing authority. They form a very suitable medium for the various Government bodies to obtain long period funds for different non-recurring expenses and help the development of public credit. The banks of this country invest some of their funds in these Government Bonds.

In other important countries of the world as well such securities are issued by their governments from time to time. For example in the United Kingdom some of these loans in force sometime back were Conversion Loan $3\frac{1}{2}$ per cent., War Loan, Victory Loan, etc. and they were quoted in the London Stock Exchange at £ 107 $\frac{1}{2}$, £ 106, and £ 115 $\frac{1}{2}$ respectively. One more point worth noting in this connection is that the government of a country may float such a loan inside its own country or in case it finds cheaper money in some foreign country, the loan may be floated by it in that foreign country. For example some of the loans raised by the Government of India in the London Money Market some time back were Indian Loan 5 per cent., Indian Stock 3 per cent., Indian Stock $3\frac{1}{2}$ per cent, etc.

8. *Exchequer Bills*.—During the World War of 1914-18 these were issued in large numbers in the United Kingdom, but after that they were replaced by Treasury Bills. They were bonds payable to bearer and were repayable after a fixed time say 1, 2, 3, 6, or 12 months from the date of issue. They were commonly issued at a discount and were repayable at par, the difference between the two amounts represented interest allowed to the subscriber for the period of the bill on the amount advanced. They were transferable documents and constituted a good source for the Government to obtain short period funds to meet its emergent expenditure in anticipation of the collection of its yearly revenue.

9. *Treasury Bills*.—In India for the first time these bills were issued by the Government on November 25, 1790 to raise money for war purposes and are issued even now. Then they were made also legal tender for all payments to the Government. The form and procedure of issue of the

old treasury bills were slightly different from those of modern treasury bills but the underlying principle has all along been the same i.e. issue in anticipation of collection of public revenue. These are bills payable after a duration of three, six, nine or twelve months from the date of issue. They are sold by the Government of India by inviting tenders to the persons who quote the highest rates. Tenders are invited from the public for a specified amount. The tenders are opened on Tuesdays and the highest tenders that is tenders demanding the lowest rates of discount or interest aggregating to the amount required are accepted. The tenderers are then given the treasury bills on payment of the amounts due. The Government is not bound to accept any tender whatsoever. The amount of tenders accepted by the Government depends upon its needs and the rates of discount demanded. These bills are issued at a discount and are repayable at par the difference being the interest that the purchaser earns for the advance of his funds.

If the entire amount required against offer of treasury bills is not received when allotment is made on Tuesday Government sells at a fixed price during the following week what are known as Intermediate Treasury Bills. Usually the rate of discount allowed for such bills is the average rate allowed on the accepted tenders on previous Tuesday. These bills constitute a good medium for the Government to raise funds for short periods of time. These bills perform a useful function during the slack season of the money market, because the investors generally traders and bankers thereby are enabled to invest their surplus funds at profitable rates. Banks in India generally resent the issue of these bills because thereby they find the Government a strong competitor for merchants surplus money seeking short term investment. But for the investors these bills are an excellent form of security because there is no risk of any capital depreciation and in case the holders be in need of ready money they can very easily discount the bills held by them with banks or other financiers in the market. These are transferable documents and help the development of short period credit very largely.

10 *Treasury Notes*.—Treasury Notes of £ 1 and 10 Shillings were issued in England in 1914 as a War emergency measure. They were secured by a reserve of silver bullion, notes of the Bank of England and certain government securities. They were put into circulation through the Bank of England and were made legal tender for all payments. Consequently they were highly transferable from person to person. Although theoretically it was possible for the holders of these notes to obtain gold in their exchange, yet gold was rarely paid out. During the War of '94-'18 these notes formed the bulk of till money of banks in England, but soon after it they were withdrawn from circulation.

11. *Council Bills*.—Every year the Government of India incurs various expenses in England. They are commonly known as 'Home Charges' and amount to about £35 millions a year. They are paid every year by the Government of India to the Secretary of State for India, who disburses the amount in England on behalf of the Indian Government. For this the Government of India has to remit every year to the Secretary of State for India a large sum of money. Some time back for this transfer of funds from India to England the procedure usually adopted was for the Secretary of State to draw a number of rupee demand drafts on the Government of India and sell them in England by inviting tenders. These were commonly known as 'Council Bills' and used to be allotted to the highest tenderers. They were generally purchased by English importers who had to remit money to India for goods purchased. Thus the Secretary of State for India used to obtain funds in pounds, shillings and pence and make the necessary payments. These drafts were then forwarded by their purchasers to their Indian creditors and used to be paid out here, on behalf of the Indian Government, through the various branches of the Imperial Bank of India. If any person in England desired to remit money to India immediately, he could purchase from the Secretary of State for India a Telegraphic Transfer, which was really a Council Bill in a telegraphic form. For this he was required to pay a price slightly higher than the price of Council Bills.

These credit instruments were greatly used by merchants in England to pay off their Indian exporters. Both the Council Bills and Rupee Telegraphic Transfers were transferable documents. Since 1923, the above procedure of remitting funds from India to England by drawing Council Bills or Telegraphic Transfers has been more or less abandoned. Now the Government of India usually purchases in India sterling bills through the Reserve Bank of India and forwards them to the Secretary of State for India, who obtains funds in England by collecting or cashing these bills and incurs the expenses on behalf of the Indian Government. In case funds are required in England by the Secretary of State immediately, the Government of India remits money by purchasing Sterling Telegraphic Transfers. Now these purchases of sterling in India are made sometimes by inviting public tenders, while at other times by private purchase. For various reasons this procedure of purchasing sterling drafts is regarded as better than the old procedure of drawing Council Bills.

12. *Reverse Councils.*—Some time back when the Government of India desired to obtain any funds from the Secretary of State for India, the Governor General of India or Council used to draw a number of sterling demand drafts upon the Secretary of State for India and used to sell them here to the highest bidders (really means those who quoted the lowest exchange rates) by inviting tenders. These drafts were known as Reverse Councils and were paid for by the Secretary of State for India in England out of the Exchange Standard Reserve. These drafts were drawn by the Government of India also on occasions, when the rate of exchange tended to fall below the lower gold point. They used to be purchased here in India by those who had to send money to England i.e., the importers of goods Indian parents who desired to send money to their wards receiving education in England, and those English-men in service or trade in India who desired to send money to their family members in England. In financial circles in India the sale of these Reverse Councils was also known by the name of 'Sale of Sterling by the Government'.

Reverse Telegraphic Transfers could also be obtained by those who desired to remit money at once, but for these they had to pay a price slightly higher than the price of ordinary Reverse Councils. Both the Reverse Councils and Sterling Telegraphic Transfers were transferable credit instruments. Now the sale of these Reverse Councils has been abandoned by the Government of India and this work is done for it by the Reserve Bank of India.

13. *Postal or Bank Cash Certificate*.—A Postal Cash Certificate is issued by any post-office to any person who pays the price in cash according to the amount fixed by the Postal Department for the time being. Postal Cash Certificates are of different denominations *e. g.*, Rs. 10/-, Rs 50/-, Rs 100/-, Rs 500/-, Rs 1000/-, etc. They are issued at a discount and are repayable at par after five years, the difference being the amount of interest that the purchaser of a certificate earns on his investment for those five years. The holder of a postal cash certificate, if he so desires can obtain cash from the post-office also before the maturity of the certificate. The amounts that a person can obtain for a cash certificate before its due date and at different intervals of time after the date of its issue are shown on the back of every certificate. These amounts are graded progressively according to the time that passes after the date of its issue. For cashing a certificate before the expiry of one year from the date of its issue, no interest is allowed. After that period amounts that are payable at the end of each quarter of a year are shown.

The amount at which a postal cash certificate of a particular denomination can be purchased differs at different times according to official announcements, which are based on the fluctuations of the bank rate and the market rates of interest. A postal cash certificate is issued in the name of a person. Consequently it is not a transferable document. These certificates offer a good source of secure investment of small sums of money. A good deal of money of this country is invested in them and they have become very

popular. Some of the banks such as the Central Bank of India Ltd, Bombay, The Jwala Bank Ltd., Agra, etc., have also begun to issue cash certificates of the postal type payable at the end of various stipulated periods of time. During the present war the Government of India Postal Department has also begun to issue 10 Years Defence Savings Certificates, which are also very much like the Postal Cash Certificates.

Specimen of a Bank Draft

No 45820

140/2345

Allahabad Bank Limited

Affiliated to the P & O. Banking Corporation Ltd

Rs 100/-

Allahabad, the 6th of February 1944

Pay to Babu Gaya Prasad or order
Rupees One Hundred only and place
the same to account of the Allahabad Bank Limited,
Allahabad Branch.

To

The Manager,
Allahabad Bank,
Calcutta.

For the Allahabad Bank Limited,

R. D. Singh,
Agent.

G N Tandon,
Accountant.

14. *Bank Draft*—A bank draft is a bill of exchange drawn by one bank upon one of its own branches, which may be situated within the same country or in some other country of the world, directing the latter to pay a certain sum of money to, or to the order of a certain person. When a banker issues a bank draft he generally asks the customer to fill in a form whereby the latter has to intimate whether his account should be debited with the amount of the draft or he shall send a cheque to the banker for the said amount. A bank draft is generally payable on demand and hence needs no acceptance, and no days of grace are allowed for its final payment. A bank draft may be inland or foreign. Foreign bank drafts are generally more popular than the

inland ones. A bank usually charges a commission on granting or issuing a bank draft. In case of a foreign bank draft the person who desires to have it, is required to pay here in Indian currency an amount calculated according to the current rate of exchange plus commission of the banker. A bank draft is a negotiable instrument and can be transferred by indorsement and delivery. Though generally a bank draft is made payable on demand, yet it can also be made payable after a certain time.

A bank draft may be drawn by one branch of a bank upon another branch or the head-office, or by the head-office on any of its branches. According to English Law a bank draft drawn by one branch upon another branch of the same bank or on its head-office, or by the head-office on any of its branches can not legally be regarded as a cheque or a bill of exchange. The drawer and the drawee of such drafts constitute only one legal person, while according to Section 3 of the English Bills of Exchange Act 1832, a bill of exchange or cheque must be drawn by one person upon another. Thus in England bank drafts are legally considered as promissory notes. On the other hand according to Section 5 of the Indian Negotiable Instruments Act 1981 in India it is not necessary that the drawer and the drawee of a bill of exchange must be independent parties. Hence in India such bank drafts can be legally treated as bills of exchange. Further if a bank draft in India is drawn payable on demand it can legally be treated even as a cheque. It should however be noted here that in India according to Section 24 of the Reserve Bank of India Act 1934, a bank draft can not be made payable to bearer as well as on demand, for the issue of such documents now is the exclusive monopoly of the Reserve Bank. A bank draft is more advantageous than a money-order or postal-order, because it can be obtained for any amount, and that it is fully negotiable instrument unless its transfer is restricted by making it payable to a named person only.

A banker must pay a bearer bank draft only to a holder

in due course, and in case he does so he becomes free from his liability to any other person by virtue of Section 82 (c) of the Indian Negotiable Instrument Act 1881. On the other hand if a bank draft is payable to order, which is generally the case, the banker should pay it only when the draft purports to have been indorsed by or on behalf of the payee, and then only he will be discharged from his liability if he pays it in due course. A bank draft can also be crossed; but the crossing of a bank draft has no legal significance, though in practice a banker usually endeavours to abide by the obvious intentions of the drawer or holder. Further it should be noted that the term 'banker's draft' does not include drafts on demand or after sight or after date drawn by one banker upon another, for such instruments are merely cheques or bills of exchange, and as such are subject to all the statutory provisions relating to those instruments. Neither does this term include drafts or orders drawn by one banker in favour of another banker for the settlement of clearing differences or other accounts between the bankers concerned. Documents of the latter kind are described as 'bankers' payments', and are exempt from stamp duty.¹

Specimen of a Bank Post Bill

Central Bank of India Ltd. Bank Post Bill.

No. 1264.

Central Bank of India Limited.

Lucknow, October 15, 1944



Thirty days after sight I promise to pay this, my sole bill of exchange, to Mr K C Khanna, or order Rupees Two Hundred and Fifty only, for value received

Rs. 250/-

For the Central Bank of India Limited,

L. N. Agarwal

A. G. Sondhi

Accountant.

Agent.

15. *Bank Post Bill.*—These are bills issued by banks for various sums of money and are made payable at seven to

sixty days after sight. They are issued free of charge and are very convenient medium of remittance of money from one place to another in the same country. These bills are issued either against a deposit of an equal sum in case of outsiders or non-customers or against a cheque of the amount in case of a customer of the bank. The interest that accrues on the amount from the date of issuing the bill to the date of its final redemption is regarded as adequate remuneration for the trouble undertaken by the bank in issuing the bill. It should be noted that a bank post bill is payable from that very office or branch of a bank which has issued it, while a bank draft is payable from that office or branch upon which it has been drawn. Thus though a bank draft is a bill of exchange a bank post bill is a sort of promissory note. Consequently a bank post bill does not require any acceptance, and may be made payable to or to the order of a certain person, or to the bearer thereof. A bank post bill is therefore a negotiable instrument and can be transferred by indorsement or delivery or both whichever be necessary. Here also the issuing banker is liable to pay to the holder in due course, and in case he does so, he is free from his liability to any other person by virtue of Section 82 of the Indian Negotiable Instruments Act 1881.

Specimen of a Letter of Credit

THE ALLAHABAD BANK LIMITED, ALLAHABAD.

No L/C. 43.

Allahabad, February 5, 1939.

To

The Allahabad Bank Limited, Bombay.

Dear Sir,

When this Letter of credit is presented to you by Mr. Gopal Narain Anand, please furnish him with such funds as he may require not exceeding Rs 5,000/- (Rupees Five Thousand only), against his sight drafts drawn upon this Bank, each draft bearing the clause, "Drawn against L/C. 43".

I hereby declare that this credit will remain in force for a period of three months from the above date, and for all

amounts paid by you to Mr. Gopal Narain Anand under this credit according to the above conditions you can debit the account of the above branch

All payments made under this credit must be inscribed on the back of this letter, and that you should retain this letter as soon as the final draft exhausting the amount of credit granted has been paid by you.

The holder's signature is given below and you are requested to satisfy yourself by referring to it that the payment is made to the proper party.

Yours truly,

For the Allahabad Bank Ltd, Allahabad,

G. Allen,

Manager.

Signature of Mr Gopal Narain Anand.

Gopal Narain Anand.

16. *Letter of Credit*—A Letter of Credit as the name indicates is a letter written by one person or bank to another requesting the latter to pay any amount of money upto a certain limit to the person named in the letter or in whose favour the letter is written. In this letter generally a date is fixed upto which only advances should be made by the addressees. Thus a letter of credit remains in force upto a certain date only. Generally these letters of credit are granted by banks. In India they are commonly issued by indigenous bankers as well. A letter of credit may be addressed to one person only or to several persons. In the former case it is known as an Ordinary or Simple Letter of Credit, while in the latter case it is known as the ¹Circular Letter of Credit. The person or persons addressed in the letter may be agents, correspondents or branches of the bank or banker issuing the letter. The persons addressed are requested to make the said advances and charge the sum or sums so paid against the granter of credit, or draw for the advances made bills of exchange on the granter of the credit. The addressees are also requested to endorse all the advances

made by them upon the back or the margin of the letter so that the letter may always indicate how much of the original amount of the credit has actually been advanced and how much of it is still out-standing or not withdrawn.

The person in whose favour a Letter of Credit is issued is required to deposit an equivalent sum in advance of the issue of the letter. Outsiders generally make a deposit while the customers may simply issue a cheque on their current account, but in all cases instructions for the issue of a letter of credit are taken by the issuing banker on special form used for the purpose. On the issue of these letters the bank charges its remuneration for the trouble caused to it in addition to the amount which the customer has to pay as equivalent to the amount for which the letter of credit is obtained. This letter may be addressed to correspondents in the same country or abroad. The former is known as an Inland Letter of Credit, while the latter is known as Foreign Letter of Credit. In case of a foreign letter of credit the banker asks the customer to pay an equivalent amount in home currency calculated according to the current rate of exchange.

A letter of credit is issued in favour of a particular person only. Hence it is neither negotiable nor transferable. Payment of a letter of credit can be obtained only by the person in whose favour it is issued. For purposes of proper identification the specimen signature (of the person in whose favour the letter is issued), is embodied in the letter itself and thus the correspondents are enabled to compare it with the signature of the man, who receives the advances when made. Generally a bank when it issues a letter of credit in favour of any person, it informs its correspondents to whom the letter is addressed that he has done so, so that they may be prepared before-hand to honour the letter when presented.

Specimen of a Circular Letter of Credit

THE CENTRAL BANK OF INDIA Ltd, CAWNPORE

No A/56

Cawnpore November 20, 1944

To the Head Office, Branches and Agents of
The Central Bank of India Ltd, Bombay

Gentlemen.

When this Letter of Credit is presented to you by Mr Man Mohan Saksena, you please furnish such funds as he may require to any amount not exceeding in the aggregate Rs. 20,000/- (Rupees Twenty Thousand only), against his sight drafts drawn upon this Bank, each draft bearing the clause "Drawn against L/C No A/56".

I hereby under-take that all such drafts shall meet my due honour if negotiated within a period of six months from this date

All payments made under this Credit must be inscribed on the back hereof, and this letter itself should be cancelled and attached to the final Draft exhausting the amount

The holder's signature is given below and you are requested to satisfy yourselves by referring to it that the payment is made to the proper party, the drafts being signed in your presence.

I am Yours truly,

Signature of
Man Mohan Saksena —
Man Mohan Saksena

For the Central Bank of India Ltd.
Cawnpore Branch
Ram Chandra Manager

On the back is printed —

Sums Drawn Under the Credit Given on Reverse

Date when paid	By whom paid	Address	Amount paid in words	Amount in figures			Signature of paying banker or correspondent
				Rs	as	p	

17. *Circular Letter of Credit.*—A Circular Letter of Credit is different from an Ordinary Letter of Credit for it is addressed to several branches, agents or correspondents of the issuing banker instead of to only one of them. The amount of credit can be taken in cash or against bills of exchange drawn, which depends upon the condition of the letter from any one, all, or any combination of the addressees of the letter; but in all that the accredited party can receive from all or any correspondent of the bank shall not exceed the amount of credit sanctioned. The addressees are required to inscribe on the back of the letter all advances that they make in the form of a table given on the last page and before making the advance to compare the signature of the holder of the letter with the specimen signature of the beneficiary given at the bottom or in the margin of the letter of credit. For this comparison the correspondents ask the grantee of the letter to sign his drafts or cheques in their presence. The addressees are requested by the issuing bank to do so in order to ascertain that they make the payment to the right person, for responsibility for correct payment lies on them.

The grantee is required to mention clearly the number and date of the letter of credit against which he draws the cheque or the draft and submit it for payment along with the letter of credit, which is returned if necessary to the grantee after the payment has been made. If the draft or the cheque which is cashed exhausts the outstanding balance the letter of credit is retained by the paying correspondent, is cancelled by him, and after inscribing the necessary entries on the back thereof is returned to the issuing bank along with the cheque or the draft paid. This form of letter of credit is really very useful to the tourists, who move from place to place and need money at different places in different or the same currency. Thus it may be an *Inland Circular Letter of Credit* or an *International Circular Letter of Credit*.

For all advances that the correspondents make against a Circular Letter of Credit, they are authorised to recoup themselves by drawing sight bills on the issuing bank. A Circular Letter of Credit must be studied by the paying

correspondent very carefully before paying any amount thereunder for all payments made against an out of date or exhausted letter of credit create no liability on the issuing banker to pay for them and as such the paying banker does so at his own risk. For rendering this service the issuing banker charges his own commission, while he has to pay some remuneration to paying or cashing bankers for their share of the facility given. In India foreign letters of credit are issued by Thomas Cook & Sons P. & O. Banking Corporation, etc., while inland letters of credit are issued by most of the Indian joint stock banks.

Specimen of a Traveller's Cheque

LLYODS BANK, CALCUTTA

Payable by all Branches Agents and Correspondents of the Bank Payable within twelve months from February 1, 1935.

No A/265

Drawer's Endorsement.—*H. Banbury*

(To be signed in the presence of the paying bank)

To

The Llyod's Bank Calcutta

Pay self or order

Signature of
Drawer

} *H Banbury*

Ten Rupees

Witness to
signature of
drawer

} *William Bose*
Manager,
Calcutta Branch

or the equivalent abroad at current rates of exchange.

18 *Traveller's Cheque* Travellers Cheques are very useful to tourists or travellers for against delivery of these the holder can obtain funds from any Branch Agent or Correspondent of the issuing bank and larger is the number of these agencies of payment the greater is the facility to the holder of these cheques. Every cheque form is of a fixed amount already printed on it. The cheque form has a place where the grantee has to sign in the presence of the paying banker. When these cheques are granted by the issuing banker, the grantee is asked to sign all the cheques in his presence. This enables the paying banker to compare the signatures

and ascertain if the payment is being made to the right person. This method of granting credit to a tourist or traveller is more convenient and advantageous than the method of Circular Letters of Credit. As such in the advanced countries of the world now Traveller's Cheques are fast displacing Circular Letters of Credit. In India they are issued by Thomas Cook & Sons, American Express Co, etc.

Negotiability of Credit Instruments

We have now studied a number of credit instruments. In our study of these instruments, we have seen that some of them are negotiable instruments, some semi-negotiable instruments, some transferable with the permission of the issuer, and some not transferable at all. For purposes of ready and quick reference here is given a chart of the different credit instruments under these four heads:—

A Negotiable Instruments.	B. Semi or Not-negotiable Instruments.	C. Transferable with the Approval of the Issuers.	D. Not-transferable or Non-negotiable Instruments.
1. Cheque.	1. Exchequer Bill or Bond.	1. Government Promissory Note.	1. I O U.
2. Bill of Exchange.	2. Treasury Bill.	2. Government Bond.	2. Postal or Bank Cash Certificate.
3. Promissory Note	3. Bearer Debenture Certificate.	3. Debenture Certificate	3. Letter of Credit.
4. Hundi.			4. Mortgage Deed.
5. Bank Draft.			
6. Bank Post Bill.			
7. Traveller's Cheque.			
8. Council Bill.			
9. Reverse Council Bill.			
10. Treasury Note			

A. Negotiable Instruments—A negotiable instrument is that instrument in whose case the transferor, in spite of the fact that there may exist a defect in his title over the instrument, be able to give a better title to the transferee, provided the transferee takes the instrument in good faith, for consideration, and before the due date of the instrument. According to Section 13 of the Indian Negotiable Instruments Act 1881 cheques, bills and promissory notes are examples of negotiable instruments.

B. Semi-Negotiable Instruments—These are those instruments which can be transferred by their holders to others without obtaining the permission or approval of those who may have issued them, but in whose case the transferor is not able to give a better title to the transferee than what he himself has over the instrument. These instruments may be negotiable by delivery only or by endorsement and delivery both combined.

C. Instruments Transferable with the Approval of the Issuer.—These are credit instruments that are transferable. Transfer of a credit instrument of this type according to the terms and conditions of the instrument does transfer the value contained in it from the transferor to the transferee, but in this case before the transferor is able to effect the transfer, he is required to take the permission or approval of the issuer of the instrument.

D. Not transferable Instruments—These are credit instruments which can not be transferred by their holders to others, and which must be realised by the holders themselves from the issuers or their agents. These instruments are of course assignable.

Questions

1. What is a cheque? Prepare a specimen of a cheque and cross it specially. What is the advantage of crossing a cheque? Explain.
2. What is a bill of exchange? How does the use of bills of exchange develop credit in a country? Explain and prepare a specimen of a bill of exchange.
3. What is a promissory note? How does it differ from a bill of

exchange? Which of the two instruments is safer from the point of view of a creditor? Explain.

4. Prepare a specimen of an ordinary promissory note and differentiate it from a currency note.

5. What is a *hundi*? What part is played by *hundies* in the credit development of India? Describe.

6. What is the difference between a *hundi* and a bill of exchange? Explain fully.

7. Prepare an I O U., and describe how it differs from a promissory note.

8. What is the difference between ordinary promissory notes and the promissory notes of the Government of India? Explain fully.

9. What are treasury bills? What part do they play in the money market of India? Describe.

10. Explain the difference between a council bill and a reverse council. What are their substitutes now? Describe.

11. What is a bank draft? Prepare its specimen and describe fully its use among businessmen.

12. What is the difference between a bank draft and a currency note? Explain fully.

13. What is a bank post bill? How does it differ from a bank draft? Describe.

14. What do you understand from a letter of credit? What are its most important kinds? How do letters of credit help businessmen? Describe.

15. Distinguish between an ordinary and a circular letter of credit. What precautions are taken by paying bankers while paying money against letters of credit presented? Describe.

16. What are travellers' cheques? How do they help the tourists and travellers? Explain.

17. Differentiate between a traveller's cheque and a circular letter of credit. Which of the two is better from the point of view of the holder and how? Explain.

18. What is meant by transferability of a credit instrument? Divide the various credit instruments into different kinds in respect of their transferability and explain those kinds.

19. What is the difference between a negotiable and a semi-negotiable credit instrument? Explain the difference and name at least three instruments of each kind.

20. What is a credit instrument? Name any three credit instruments and explain how the use of credit instruments helps the development of credit.

CHAPTER XV

FOREIGN EXCHANGE

Definition, Origin and Development

If all countries of the world used the same kind of money, for example, Rupees, Pounds Sterling or Dollars, the task of international payments would be a simple one, for an exchange between two countries does not fundamentally differ from an exchange between any two persons belonging to the same country. The difficulty really arises from the fact that almost every country of the world has a distinctive money or currency standard of its own differing from the standard moneys of other countries not only in name but also in shape, size and intrinsic value. Thus "foreign exchange is that branch of the science of Economics in which we seek to determine the principles on which the peoples of the world settle their debts one to the other."¹

Theoretically the term foreign exchange is applied to the systems by which the people of a country discharge their indebtedness to the people of other countries. Practically this is one of those unfortunate terms which is capable of several meanings and in different contexts it is used in widely different senses. Sometimes foreign exchange refers to a foreign currency which is bought or sold, while at another time to the rate or the ratio at which the currency of a country exchanges in terms of the currency of another. Sometimes it also denotes a foreign bill of exchange which is purchased or the institution from which it is purchased. Foreign exchanges of a country provide her people the means by which and the costs at which they can pay their foreign debts contracted in the moneys or currencies of foreign countries. They give them opportunities of exchanging the money of their country for something which enables their creditors in foreign lands to

¹Principles & Arithmetic of Foreign Exchange by S. Evelyn Thomas
page 1.

obtain their own moneys which they desire. Secondly foreign exchanges enable persons of a country to whom debts are due in foreign currencies the opportunities of exchanging those rights to foreign currencies into the money of their own country. Thus foreign exchanges of a country are the indices of the international values of its money .

As the values of all commodities and services in different countries are measured and expressed in terms of their standard moneys, a foreign exchange between any two countries is the ratio of the values of the standard moneys of the two countries, or the value of the standard money of one country expressed in terms of the standard money of another. Thus Indian foreign exchange with England at any time means either the number of rupees that will buy one pound sterling in England, or the number of rupees that a person who has a credit of one pound sterling in England can obtain in exchange of it in India. Foreign exchange rate between any two countries of the world is always measured and expressed in terms of the standard money of either of the country according to the custom. Thus, theoretically there may exist a foreign exchange rate between any two countries of the world, but practically there exists one only between two such countries which are connected with each other through foreign trade relations, which usually give rise to the problem of mutual indebtedness and consequently the need of the settlement of that indebtedness through the machinery of foreign exchange.

Up to the middle of the 17th century international trade was not largely developed. Goods used to be carried from one country to the other and exchanged for the goods of the latter directly or through the medium of the standard money of the latter country. Consequently in those days it was a sort of international barter system of exchange or trade. Till the close of the 18th century most of India's foreign trade with the European countries as well used to be carried on under the above barter system. In 1835 the East India Company established in India an organised system of cur-

rency with silver rupee as the standard money. During the 19th century India's trade with the European countries and particularly England increased very much and there arose the question of Indian foreign exchange with England or the value of one silver rupee of India in terms of gold pound of England. This relation of the values of the Indian rupee and English pound, or the value of the Indian rupee expressed in terms of English pound or the value of English pound expressed in terms of Indian rupees is called India's foreign exchange with England. During the last fifty years or so India has developed her foreign trade relations with almost all the other industrially and commercially advanced countries of the world. Consequently expressions of the value of the Indian rupee are now made in terms of the standard moneys of all those countries and these ratios are known as India's foreign exchanges with them.

For purposes of foreign exchange it is not necessary that expressions of the value of Indian rupee should always be made in terms of the standard moneys of other countries, or that the expression should always be of one unit of the standard money of India or of one unit of the standard money of any other country of the world. Foreign exchange rates of a country may be expressed in terms of any unit of currency of that country or in terms of any unit of currencies of other countries with which it has to deal. Moreover this ratio or rate may be expressed in terms of only one unit of the standard money of a country or in terms of any other suitable number or fraction thereof. For example India expresses her foreign exchange rate with England in terms of English currency such as Rs 1 is equal to 1s 6d, while it expresses her exchange rate with Japan in terms of her own currency such as Rs 77½ are equal to 100 Yens. For England India quotes exchange value of one rupee, while for Japan India quotes exchange value of 100 Yens.

With the development of international trade on a large scale and as such the need of foreign exchanges in large quantities there came into being many banking institutions which specialise in the business of selling and purchasing

foreign exchanges. They are commonly known as foreign exchange banks such as The Chartered Bank of India, Australia & China, The P & O. Banking Corporation; Yokohama Specie Bank; etc. These banks have branches or agencies in all those countries of the world the foreign trade of which they finance by selling and purchasing their foreign exchanges. The number of these banks and other persons who deal in foreign exchanges has now so much increased that in almost all the important countries of the world there are at present regular exchange markets, where foreign exchanges of the different countries can easily and quickly be sold and purchased either directly or through exchange brokers. Generally these markets form an important part of the money markets of the various countries and are situated at port towns *e.g.*, Bombay and Calcutta Foreign Exchange Markets in India. For the convenience of the people who deal in foreign trade and as such have to purchase and sell foreign exchanges very frequently regular reports of these foreign exchange markets are published in important general and technical papers and from these reports can be ascertained the latest foreign exchange rates of a country with regard to the other countries of the world. In India such reports are published in the 'Leader', 'Statesman', 'Capital', 'Indian Finance', and other important papers of the country. Below is given a specimen of the Calcutta Foreign Exchange Market Report:—

Friday, May 22, 1936.

The market has been stagnant. Sterling rates may be quoted as follows :—

Banks Selling :—

Tele. Transfer	1s 6 3/32d.
On Demand	1s 6 3/32d.

Banks Buying :—

3m/st Bills	1s 6 7/32d.
4m/st Bills	1s 6 1/4d.
6m/st Bills	1s 6 5/16d.
Sight	1s 6 5/32d.
T. T.	1s 6 5/32d.

Other rates are as follows :—

Countries	Method of Quotation	Banks Selling a/d.	Banks Buying. 30 d/st.
France	(Froncs per Rs 100)	563	...
Americo	(Rupees per \$ 100)	267	...
Hongkong	(Rupees per \$ 100)	87½	83 3/4
Shonghal	(Rupees per \$ 100)	80½	77
Singapore	(Rupees per \$ 100)	156	154 3/8
Japon	(Rupees per Yens 100)	27 3/4	77
Javo	(Guilders per Rs 100)	55	55 3/4
Germany	(Marks per Rs 100)	92	...

Cable Quotations :—

London-N York (Dollars per £) 4 97 1/32 B C Tl. Rate 1s 6 1/32d
 London Paris (Francs per £) 75 48 B.C O D Rate 1s 6 1/32d

Mint Par of Exchange

When a person sells goods to another or has to receive a payment on some other account, what he demands is that he should be paid in terms of currency of his country. If the debtor and the creditor live in the same country and thereby use the same currency, there is no difficulty in receiving or making the payment. The debtor can make the payment in the same currency in which the creditor likes to receive it. If however, the debtor and the creditor live in two different countries and the currency systems of the two countries differ, which is very often the case; the difficulty that arises is that the debtor can conveniently make the payment in terms of currency of his country, while the creditor likes to receive the payment in terms of currency of his country. This difference in the currency systems or the standard moneys of the two countries leads to a system of foreign exchange between them. Thus differences in the currency systems or standard moneys of different countries of the world lead to various foreign exchanges between them.

In every transaction value or amount involved is fixed in terms of currency of only one country and it is either the responsibility of the debtor to make payment in terms of

currency of the creditor, or of the creditor to receive payment in terms of currency of the debtor. In case of a trade transaction if the price of goods purchased is fixed in terms of currency of the seller or the creditor, it is the responsibility of the purchaser or the debtor to make payment to the creditor in terms of currency of the latter's country by purchasing it with the money or currency of his own country. If on the other hand price of goods supplied is fixed in terms of currency of the purchaser or debtor's country, it is the seller or creditor's responsibility to receive payment from the debtor or purchaser in terms of currency of the debtor's country and bring that money to his country by converting it into the currency of his country. Suppose an American merchant purchases goods worth £ 1 from an English merchant and has to make payment of that amount to him. The moneys or standards of America and England differ. In America the standard of currency is Dollar, while in England the standard money is Pound Sterling. Here lies the difficulty and this difference in the standard moneys of the two countries leads to a system of foreign exchange between them.

In the above case it is the responsibility of the American merchant to make the payment of one Pound Sterling to his English creditor. In the absence of foreign bills of exchange the only alternative for the American debtor is to export to his English creditor that quantity of gold which the latter can easily sell in his country for £ 1. If England were a free gold currency gold standard country (as was the case so long as it had not gone off gold standard in 1940) the quantity of pure gold that the American debtor was required to export to his English creditor was the same as was contained in £ 1 i.e., 113'0016 grains. On the other hand if America were also a free gold currency gold standard country, as was the case before America adopted gold bullion standard, a Dollar in America could purchase 23'22 grains of pure gold. Thus in order to purchase 113'0016 grains of pure gold the American debtor was required to spend \$ 4'8665 or that \$ 4'8665 contained the same quantity of pure gold as was contained in £ 1.

The British Sovereign or £ contained 113 0016 grains of fine gold

The American Golden Eagle which was equal to 10 Dollars contained 232 2 grains of fine gold,

∴ One Dollar \$ = 23 22 grains of fine gold

∴ £ 1 = $\frac{113 0016}{23 22}$ or \$ 4 8665

Hence Mint Par of Exchange between London New York or Sterling—Dollar is \$ 4 8635 or £ 1 = \$ 4 8665.

The above relation between the quantities of pure metal contained in the standard coins of two countries is called parity or mint par of exchange between them Dr S E Thomas defines mint par of exchange as 'the exact equivalent of the standard coin of one country, expressed in terms of the standard coinage of another country having the same metallic standard the equivalent being determined by a comparison of the quantity and fineness of the metal contained in the two standard coins as fixed by law'¹ Thus in those days when we said that the mint par of exchange between London and New York was \$ 4 8665 we meant that the value of pure gold contained in one full-weight pound sterling was equal to \$ 4 8665.

Like the above mint par of exchange between two gold standard countries a mint par of exchange can also be fixed between two silver standard countries by finding out the relation between the amounts of pure metal or silver contained in the standard coins of the two silver standard countries It should be noted that sometimes the standards of currency of two countries differ i.e., one is a gold standard country while the other is a silver standard country and the value of one metal in terms of the other metal constantly fluctuates in the market. In such a case the mint par of exchange between those two countries does not only depend upon the relation

¹Principles & Arithmetic of Foreign Exchange by S. E. Thomas, page 44

of the quantities of pure metals contained in their standard coins; but also upon the relation of their market values, which constantly fluctuates.

The mint par of exchange between England and India assuming them to be on the gold and silver standards respectively would be calculated as follows:—

The Rupee contains 165 grains of fine silver or $\frac{165}{480} = \frac{11}{32}$ oz.37 oz. of fine silver = 40 oz. of standard silver.

∴ The amount of standard silver contained in the

$$\text{Rupee} = \frac{11}{32} \times \frac{40}{37} = \frac{55}{148} \text{ oz.}$$

Now, if the price of standard silver is supposed to be 43 d. per oz., the value of silver contained in the rupee will be $= \frac{55}{148} \times 43 = 16 \text{ d.}$

But, if the price of standard silver is 48 d. per ounce, the price of silver contained in the rupee will be $= \frac{55}{148} \times 48 = 18 \text{ d.}$

Consequently inspite of currency regulations remaining the same (*i.e.*, the weights and percentages of purity of metals of the two standard coins remaining unchanged) there can not be any permanent mint par of exchange between a gold and a silver standard country. Therefore the mint par of exchange between two gold standard countries or between two silver standard countries is a fixed ratio and it does not change unless either the weight or the percentage of purity of metal of either of the two standard coins is changed. On the other hand a mint par of exchange between a gold standard country and a silver standard country constantly fluctuates as the relation of their market values changes. Before 1893 India had a free silver standard while England had a free gold standard and the relation of the market values of the two metals changed from time to time very much according to the conditions of their demand and supply. Consequently the mint par of exchange between India and England in those days did not remain fixed for any adequate length of time.

It should be noted that sometimes the standard money of a country is made of silver or paper but its exchange value is fixed by statute in terms of gold *i.e.*, the currency authority of the country is under statutory obligation to give and receive gold for and against certain units of standard money of the country at a certain fixed rate. These are usually called the gold and bullion exchange standards and were commonly adopted in the different countries of the world after the Great War of 1914-18. The mint par of exchange between a gold currency gold standard country and a gold or bullion exchange standard country is calculated on the basis of the relation of the amount of pure gold contained in the standard coin of the former with the statutory gold exchange value of the standard money of the latter.

If however both the countries of which a mint par of exchange has to be calculated have a gold or bullion exchange standard the mint par of exchange between them would depend upon the relation of the quantities of pure gold which have statutorily been promised to be given by the currency authorities of the two countries against the standard moneys of their country. Calculated according to these principles the mint pars of exchange between England and some of the other countries of the world which were in use sometime back were as follows—

France	124 213 Francs	to £ 1
United States	4 856 Dollars	to £ 1
Germany	20 429 Marks	to £ 1
Italy	92 46 Lires	to £ 1
Sweden	18 159 Kroner	to £ 1
Denmark	18 169 Kroner	to £ 1
Holland	12 107 Florins	to £ 1
Greece	375 Drachmae	to £ 1
Spain	25 221 Pesetas	to £ 1
Austria	164½ Kronen	to £ 1
Belgium	35 Belga	to £ 1

Purchasing Power Parity Theory

Sometimes the paper currency of a country becomes so much inflated that it becomes inconvertible *i.e.*, the institution issuing paper currency in the country becomes incapable of converting or redeeming its notes into the standard coins or bullion whichever may have statutorily been promised by it at the time of their issue. This is commonly known as going off the gold or metallic standard. The 'mint par of exchange of such a country with any other country on gold standard or that also off gold standard is not determined according to the relation of the statutorily promised quantity or quantities of metal of their standard moneys for in one or both of them the currency does not remain convertible into coin or bullion. The mint par or the normal rate of exchange between two such countries is obtained by comparing their price levels and tends to equal the ratio between the purchasing powers of the currencies of the two countries. This is known as the *purchasing power parity theory* of foreign exchange. This was propounded by the famous Swedish economist Prof. Gustav Cassel and he explained his theory as follows :—

"Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that money possesses a purchasing power as against commodities and services in that foreign country. On the other hand, when we offer so and so much of our own money, we are actually offering a purchasing power as against commodities and services in our own country. Our valuation of a foreign currency in terms of our own, therefore, mainly depends on the relative purchasing power of the two currencies in their respective countries.

Given—normal free trade between two countries A and B, a certain exchange rate will establish itself between them, and, apart from slight fluctuations this rate will remain unaltered so long as no variations take place in either of the currencies' purchasing power and no obstacles are placed in the way of trade. Now should an inflation of A's currency take

place, and consequently its purchasing power be reduced; the value of A's currency in the country B will necessarily fall in like proportion. Should at the same time B's currency have undergone inflation and its purchasing power have been reduced, clearly the valuation of A's currency in B will, as a consequence, rise in a corresponding degree. If, for instance, the inflation in A has reached the ratio of 320 to 100 and the inflation in B the ratio of 240 to 100, the new exchange rate (taking the quotation of A's currency in B's currency) will be three-quarters of the old rate. Thus the following rule: when two currencies have undergone inflation, the normal rate of exchange will be equal to the old rate multiplied by the quotient of the degree of inflation in the one country and in the other. There will naturally always be found deviations from this new normal rate, and during the transition period these deviations may be expected to be fairly wide. But the rate that has been calculated by the above method must be regarded as the new parity between the currencies, the point of balance towards which, in spite of all temporary fluctuations, the exchange rates will always tend. This parity I call *purchasing power parity*.¹

Specie Parity

We have seen before that the mint par of exchange between two countries is the ratio of their standard moneys based upon either the intrinsic values of the metallic contents of their standard coins or upon the statutorily promised quantities of pure gold against the standard moneys of the two countries or upon the purchasing power of the standard moneys of the two countries at any particular time. Thus payment of one unit of standard money of a foreign country can be made by a person of the debtor country by spending that number of standard money of his home currency which form the mint par of exchange of his country with the currency of the other or the creditor's country. For example we have seen before that the mint par of exchange between U. S. A.

¹Money & Foreign Exchange after 1914 by Prof. Gustav Cassel, pp. 138-140.

and United Kingdom is \$ 4'8665 to £ 1 *i.e.*, a person in U.S.A., can obtain gold contained in £ 1 by spending \$ 4 8665 and as such by exporting that quantity of gold to his creditor in United Kingdom he can make payment of £ 1 to him. Similarly a person in United Kingdom can make payment of \$ 4'8665 to an American creditor by exporting gold worth £ 1 to him. But it should be noted here that in exporting gold from U.S. A., to United Kingdom or from United Kingdom to U.S A., the debtor will be required to spend some money as cost of shipping freight, insurance premium, etc. Thus a foreign payment can be made by a person by exporting specie at the mint par of exchange plus the expenses of transport of specie from one country to the other. Therefore the total cost involved in making payment to a foreigner by exporting specie is the mint par of exchange plus the expenses of transport.

Suppose the expenses of transporting gold worth £ 1 from U. S. A. to United Kingdom are ten cents. Thus the total amount of money that an American debtor will be required to spend in payment of £ 1 to an English creditor by exporting gold will be \$ 4'8665 (cost of gold) plus 10 cents (expenses of transport) *i.e.*, \$ 4'9665. This is technically called the *upper specie or gold point*. Similarly if an English merchant has to make payment of \$ 4'8665 to an American creditor and he tries to do so by exporting gold he will be required to spend £ 1 plus 10 cents expenses of transport of specie from England to U. S. A., or in other words the English debtor with his £ 1 will be able to make payment of \$ 4'8665 minus 10 cents *i.e.*, \$ 4'7665. This is technically called the *lower specie or gold point*. Thus the specie or gold points between any two countries are deduced by adding and subtracting the expenses of transport of specie to and from the mint par of exchange between the two countries.

Mint par of exchange between U. S. A. and United Kingdom.	Cost of transport of specie.	Upper Specie Point
\$ 4'8665.	10 cents.	\$ 4'8665 plus 10 cents or \$ 4'9665.
		Lower Specie Point
		\$ 4'8665 minus 10 cents or \$ 4'7665.

Similarly maximum and minimum specie points can be deduced from the mint par of exchange of any two countries of the world. In course of time we will study that these specie points between any two countries control the market rate of exchange or the price of foreign bills between them.

India's Mint Par of Exchange & Specie Points

It has already been mentioned before that from 1835 India adopted a free monometallic silver standard. Consequently from that date onward the mint par of exchange between India and England was 2s. to Re 1/- or Rs 10/- to £ 1/-. This mint par of exchange depended upon the weight and percentage of fineness of the metals in the standard coins of the two countries as well as the market gold price of silver contents of the rupee. This state of affairs continued upto 1873. From that date the gold price of silver began to fall in the market and as India was a free silver standard country, the mint par of exchange between India and England began to fall so far so that in 1893 it came down to 1s 3d approximately. Then India decided to stop the free coinage of silver rupees. Scarcity of rupees led to a divergence in the fiduciary and bullion value of the rupee, and the fiduciary value of the rupee became higher than its metallic or bullion value. The result of this was that the mint par of exchange between England and India changed its basis and began to be determined by the bullion value of the gold pound and fiduciary value of the silver rupee instead of its bullion value. The mint par of exchange between India and England based on this artificial value of the Indian rupee (due to contraction of currency), began to rise and by 1898 it came up to the ratio of nearly 1s. 4d, though the intrinsic value of the silver content of the rupee in terms of pound was still about 10 3/8d.

The Fowler Committee of 1893 recommended that so long as gold standard was not established in India the mint par of exchange between India and England be pegged and maintained at the artificial rate of 1s 4d gold, and the Government of India should try to maintain that rate by

offering to sell to and purchase from the public sterling at 1s. 3 29/32d. and 1s. 4 1/8d, the lower and upper specie points. The Government accepted the recommendation of not re-enforcing silver standard and by executive action enforced the policy of maintaining 1s. 4d. per rupee mint par of exchange between India and England as a permanent measure. In order to be able to do this it was necessary for the Government of India to have gold or sterling reserve funds available in London with the help of which the above mint par of exchange could be maintained. For this in 1900 was created the Gold Exchange Standard Reserve Fund out of the profits of rupee coinage and it was used to maintain the Indian mint par of exchange with England at 1s. 4d. This state of affairs continued up to 1913, when was appointed the Chamberlain Currency Commission, which in its report confirmed the Government policy of gold exchange standard and pegged exchange or maintenance of India's mint par of exchange with England at 1s. 4d. and specie points at 1s. 3 29/32d and 1s. 4 1/8d. per rupee, through the policy of selling reverse councils and council bills to be paid out of or to be credited to the Gold Exchange Standard Reserve Fund. The Government soon gave effect to the above recommendations, but in the meantime the Great War of 1914-18 broke out.

During the war time of 1914-18 owing to a great rise in the price of silver, the gold value of the silver contents of the rupee began to rise and the Indian currency authority could not maintain the mint par of exchange at the old rate of 1s. 4d. After great efforts the Government let loose the reins and the mint par of exchange and along with it the market rate of exchange between India and England began to rise, and went on becoming higher and higher according to the rise in the market price of silver.

Chart Showing Rise in the Price of Silver and Indian Exchange Rate from 1914 to 1919 —

Year.	Price of silver per standard ounce in London	Exchange Rate.
1914.		1s. 4d.
1915.	27½d.	
1916 (December)	37d.	1s 4½d.
1917 (August).	43d.	1s. 5d.
1917 (September)	55d.	1s. 6d.
September 1917 to May 1919 (Period of control by U S A., and British Govern- ments)		
May 1919 (After removal of above control).	58d.	1s. 10d. to 2s. 2d.
December 17, 1919.	78d.	2s 4d.

Shortly after the Great War England also went off gold standard and the market value of gold became higher than the mint price with the result that as compared to gold sterling became 22 per cent. cheaper. This state of affairs continued up to 22nd December 1919, when the Babington Smith Committee gave its report and recommended that the mint par of exchange between India and England be fixed at 2s. gold or 2s 4d. sterling. This recommendation was accepted by the Secretary of State for India and according to various Notifications issued on 2nd February 1920 the mint par of exchange between England and India was fixed at 2s gold or 2s 4d. sterling per rupee. Shortly after the announcement of the official mint par of exchange, there grew up in India a keen demand for sterling and exchange rate began to fall, and in spite of strenuous efforts the newly established parity of exchange could not be maintained and by December 1921 it came down to 1s 3 7/8d sterling or 1s. 1 5/32d gold. Then it began to recover and by October 1924 it came up to the level of 1s 6d sterling and by 1925 1s 6d. gold.

The Currency Act 1927 based on the recommendations of the Hilton Young Currency Commission fixed the mint par of exchange between India and England at the rate of 1s. 6d. gold and the specie points at 1s. 6 1/8d. and 1s. 5 29/32d. It should be noted here that at this time also the Indian mint par of exchange was pegged on an artificial value of the rupee for its intrinsic value had become lower than 1s. 6d. gold. From 1927 onward the currency authority in India maintained the mint par or parity of exchange and the upper and lower specie points according to the above new rates under a statutory obligation to buy and sell gold or sterling according to the convenience of the currency authorities with and for silver rupees. Thus the system followed in India again became a gold exchange standard and a pegged exchange. This continued up to September 21, 1931 when England again went off gold standard and a Currency Ordinance had to be made in India. According to this Ordinance No. VI of September 1931 the Government of India withdrew its obligation to sell gold or sterling at the lower specie point. On September 24, 1931, the Government issued another Ordinance No. VII of 1931 under which it cancelled the previous Ordinance and offered to sell gold or sterling at the fixed rate to recognised banks for certain purposes only. This continued up to 30th January 1932, when by another Ordinance the previous Ordinance No. VII of 1931 was repealed. Thus by means of these various Ordinances the Indian rupee was linked to sterling and not gold at 1s. 6d. per rupee. This mint par of exchange between England and India continued upto April 1, 1935, when the Reserve Bank of India Act 1934 came into force and the Reserve Bank was established.

According to Sections 40 and 41 of the Reserve Bank Act the Bank is under statutory obligation to buy and sell sterling to any person at its offices in Bombay, Calcutta, Delhi, Madras, and (Rangoon) at the rates of 1s. 6 3/16d. and 1s. 5 49/64d. per rupee in quantities of not less than ten thousand pounds. By this Act also the position of India's

mint par of exchange was not changed and the Indian rupee is linked to sterling at the rate of 1s 6d. and the upper and lower specie points thus fixed are 1s 6 3/16d and 1s. 5 49/64d. Thus the Indian mint par of exchange with England and other countries of the world occupy a peculiar position. They are not based on the intrinsic value of the standard money of India, but on an artificial value which the currency authorities in India have fixed for it in terms of sterling and which they are under statutory obligation to maintain by offering to buy and sell sterling according to rates fixed. Thus we see that it is possible for the currency authorities of a country to fix the value of their standard money for external purposes at a mint par of exchange higher than its intrinsic value, and maintain it at that higher rate by arranging to buy and sell in exchange of home currency, foreign currencies or specie at the fixed rates. The mint par of exchange between such a country and others do not depend upon the intrinsic value of the former's standard money, but upon its artificial value fixed by statute or the policy of the currency authority. Thus the specie points also between such a country and other countries of the world are determined from this artificial value and not from its intrinsic value.

It should be noted here that as the external value of the Indian rupee is fixed in terms of sterling. India's mint par of exchange with all the other countries of the world are determined through sterling and depend upon the parity of sterling with the standard moneys of those other countries. Consequently every change in the English mint par of exchange with any other country of the world brings about a change also in the Indian mint par of exchange with that other country. This is commonly described as dependence of India's currency and exchange upon English currency and exchange. *This dependence of the Indian currency and exchange upon the English currency and exchange system is harmful to the various economic interests of this country and should be reformed at the earliest possible date*

English creditor and if he does so he will be able to make the payment by spending 124 21 francs in purchasing gold worth one pound according to the mint par of exchange and approximately 10 centimes per pound he will spend in order to export that gold to England. Thus his total expenditure in making payment of one pound sterling to his English creditor will come to about 124 31 francs.

As a merchant in France imports some goods from a merchant of England similarly some other merchant of France may export some goods to some other English merchant and as such may have to receive from the English merchant a sum of £ 1. Thus it is possible that at a time in France there may be one person who has to receive £ 1 from an English merchant and another person who has to pay £ 1 to some other English merchant. If somehow it be possible to bring these two French and the other two English merchants in contact with each other it would be possible to settle the accounts of all the four merchants by payments in their own countries without the transport of any gold or specie. This can be done if the French creditor may draw a bill of £ 1 on his English debtor and sell it to the French debtor who may forward it to his English creditor asking him to realise the value of the bill from the English debtor on whom it is drawn. The following example will make the point clear —

France	Value of goods exported or imported	England
A Exporter or creditor	£ 1	P Importer or debtor
B Importer or debtor.	£ 1	Q Exporter or creditor

In the above example accounts relating to the above export or import of goods between A and P and B and Q can very conveniently be settled if A may draw a bill of £ 1 on his English debtor P and sell it to B of France who may send it to Q of England with instructions to realise the amount from P or whom the bill is drawn. Thus in England Q will be paid by P and in France A will be paid by B and there will be

no need of transport of specie to or from any of these countries. It is worth noting here that thus the settlement of foreign payments by means of bills of exchange is a cheaper and more convenient method than the transport of specie, but in this it is necessary that the total amount of bills required should be equal to the total amount of bills available. Or in other words the total amount of foreign currency required should be equal to the total amount of foreign currency available. Such a condition is possible only when a country imports exactly the same amount of goods that it exports, but in trade it is not always possible. Sometimes a country imports more than it exports, while at another time it may export more than it imports. Thus if at any time a country has imported more than it has exported, it is evident that at that time in that country the demand of foreign currency or bills will be larger than their supply, with the result that those who are in need of foreign currency in that country will offer more of their home currency per unit of foreign currency or that they would be willing to take less of foreign currency per unit of their home currency than what is the mint par of exchange between those countries. For example in the above case of England and France whose mint par of exchange is 124'21 francs to a pound sterling, people may offer up to 124'31 francs per pound or in the case of India and England whose parity of exchange is officially fixed at 1s 6d. per rupee, people may accept up to 1s. 5 49/64d. per rupee.

Further it should be noted that larger is the amount that the people of a country have to pay to the people of another country, the greater will be the demand of foreign bills or currency in that country at that time, and as such higher will be the price offered for foreign currency in terms of home currency. But there is a limit beyond which the price of these bills or foreign currency can not go whatever may be the competition of the debtors or importers to acquire foreign currency. This limit is the mint par of exchange plus the expense of transport of specie or the higher specie point in case the country quotes exchange in terms of her own currency. In case the price demanded for these foreign bills is

higher than this upper specie point people will not purchase these bills but will settle their account by transporting specie. Thus it is evident that ordinarily whatever may be the demand of foreign currency or bills in a country the price demanded for it known as the market rate of exchange can not go beyond the upper specie point.

On the other hand if at any time a country has exported more than it has imported the supply of foreign currency or bills will be larger than the demand and the competition at such a time will be on the side of exporters or creditors who would like to sell their foreign bills or currency at the best possible price. The result of this will be that people will offer less of home currency in exchange of the same unit of foreign currency or for the same unit of home currency people will demand more of foreign currency. For example in case of England and France people may offer only 124 11 francs for each pound sterling or in case of India and England the price offered may be $1s\ 6\ 3/16d$ per rupee. Here also it should be noted that the price offered for foreign currency can not fall below a certain minimum limit and that limit is the mint par of exchange minus the cost of transport of specie from the foreign country to that country. In case the price offered is lower than this limit people who possess foreign currency or bills will not sell them, but will ask their debtors in the foreign country to purchase specie and send it to them at their expense and as such these exporters or creditors will get bullion or specie for their foreign holdings at the mint par of exchange minus the cost of transport.

Thus we see that the market rate of foreign exchange or the price of foreign bills between two countries can not ordinarily go beyond the specie points and at a time depends upon the demand and supply of foreign currency in that country. It should be noted here that the market rate of exchange between two countries can not remain either at the higher or lower specie point for any great length of time for its sticking to any of these points or any other figure beyond these shall encourage the export or import of bullion which on

its own turn through contraction or expansion of the total volume of currency shall affect the general level of prices and tend to correct the export and import activities of the country and ultimately bring the exchange rate to its equilibrium. It must be remembered in this connection that for this smooth adjustment of the exchange rate it is necessary that the country should have a free gold export and import market.

It should be noted that the demand and supply of foreign bills or currency in a country arise mostly out of trade transactions, but there are several other factors as well for example stock exchange and banking transactions which necessitate the transfer of funds to and from a foreign country and thereby affect the demand and supply of that foreign currency in that country. Thus we can safely say that the market rate of exchange between any two countries on one side depends upon their mint par of exchange and the specie points deduced therefrom, and on the other on the balance of total indebtedness between the two countries which may be in the process of being paid at that time. Out of these two sets of conditions the former or the mint par of exchange and specie points are more or less stable and permanent, while the latter *i. e.*, the balance of indebtedness is constantly a fluctuating factor, and as such ordinarily between any two countries the market rate of exchange constantly fluctuates from one direction to the other, and at a time depends upon the net balance of total indebtedness of one country as against the other.

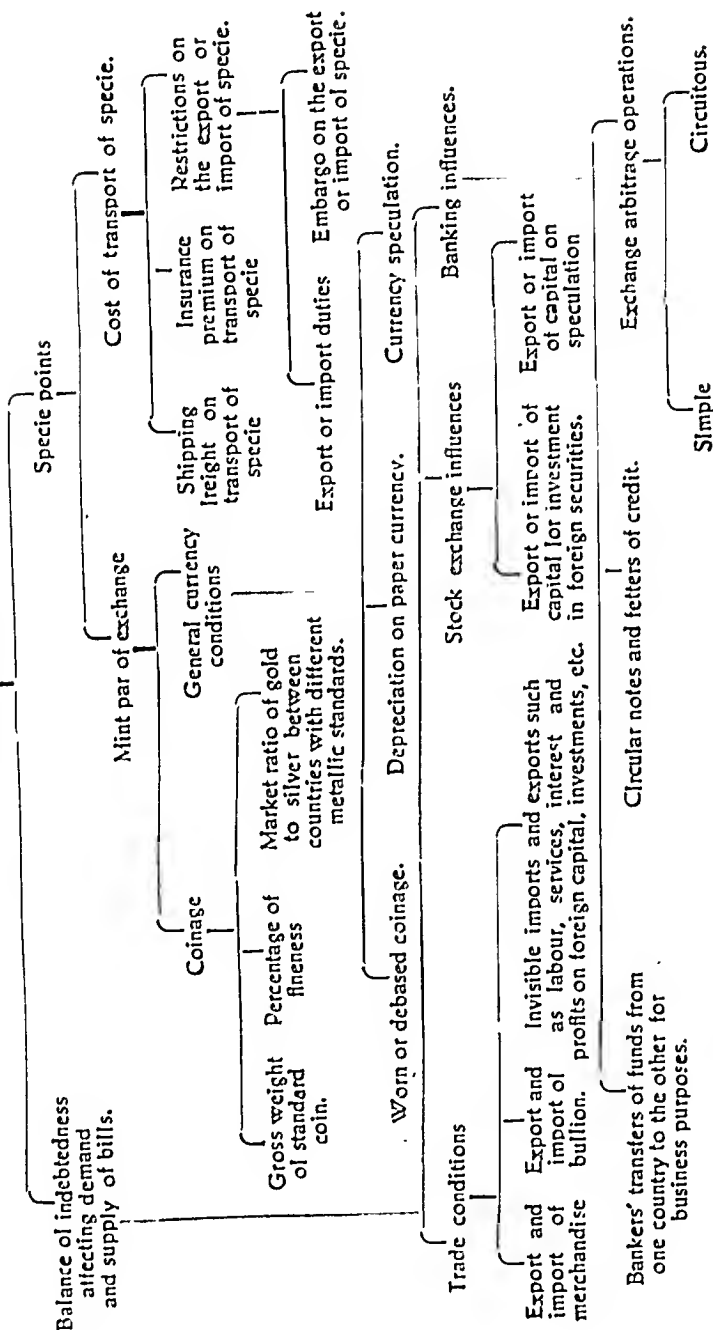
✓ If at any time according to the market rate of exchange the currency of a country exchanges for more of currency of another country than the mint par, the exchange rate is said to be in favour of the former country and against the latter. On the other hand if according to the market rate of exchange at any time home currency of a country exchanges for less of currency of any foreign country than the mint par of exchange, the exchange rate is said to be against the former country and in favour of the latter. For example we know that the mint par of exchange between India and

England is 1s. 6d. per rupee. If at any time the Indian exchange rate against England becomes more than 1s 6d. per rupee say 1s. 6 1/8d. it is said to be favourable to India and unfavourable to England. On the other hand if at any time the Indian Exchange rate against England becomes lower than 1s. 6d. per rupee say 1s 5 7/8d it is said to be favourable to England and against or unfavourable to India (Thus if a country quotes her foreign exchange with regard to some other country in terms of foreign currency, higher is the rate it is favourable to the country and lower is the rate it is unfavourable to it. On the other hand if a country quotes her foreign exchange with regard to some other country in terms of home currency, higher is the rate it is unfavourable to the country, while lower is the rate it is favourable to it.)

✓ It should be noted here that favourable and unfavourable foreign exchanges of a country affect the general level of prices of a country. (The favourable exchanges of a country by encouraging imports of foreign goods and by discouraging export of domestic goods tend to lower down the prices of all goods into that country and thereby benefit the consumers and harm the producers for some time. On the other hand unfavourable exchanges of a country by encouraging exports of domestic goods and discouraging imports of foreign goods tend to raise the prices of all goods into that country and thereby benefit the producers and harm the consumers for some time. Thus the terms favourable and unfavourable exchange rates are not absolute terms, for we see that what is favourable exchange rate to consumers of a country it is unfavourable or disadvantageous to its producers, and what is an unfavourable exchange rate to consumers of a country it is favourable or advantageous to the producers of that country

Conditions Affecting Rate of Exchange

Rate of Exchange.



We have already seen before that conditions that affect the rate of exchange between two countries at any time can easily be divided into two sets —

(1) Conditions that affect the mint par of exchange or the specie points

(2) Conditions that affect the balance of indebtedness or the demand and supply of bills.

(1) Conditions that affect the mint par of exchange or specie points

(a) A country that has a free coinage system of either gold or silver, its mint par of exchange depend upon the intrinsic value of its standard coin. Besides other factors the intrinsic value of the standard coin of a country depends upon its weight. Thus other things remaining the same the mint par of exchange of a country change with every change in the gross weight of its standard coin. Consequently the market rates of exchange of that country also change. It should however be noted that changes in the gross weight of the standard coin of a country are rarely made and as such the market rates of exchange of a country are rarely affected by changes in the gross weight of its standard coin.

(b) Another factor on which the intrinsic value of the standard coin of a country depends is the percentage of fineness of metal (either gold or silver) contained in it. In this also changes are rarely made by the currency authorities of a country. In every advanced country of the world coinage is now a function of the state and making of coins by private agency is made legally criminal. Thus changes in the percentage of fineness of metal of the standard coin are now rare and market rates of exchange of a country are rarely affected by such causes.

(c) A third factor on which the intrinsic value of the standard coin of a country in terms of the standard coin of another depends is the relation of the market values of the metals of which the two standard coins are made. In case both the standard coins are made of the same metal

either gold or silver, changes in its market value affect the two standard coins equally and as such there is no change in the relation of their intrinsic values or the mint par of exchange. On the other hand if the standard coin of one country is made of gold and of the other of silver, the mint par of exchange between the two countries depends upon the relation of the market values of the two metals, and as this relation of their values changes in the market from time to time according to the demand and supply of the two metals, the mint par of exchange also between two such countries changes accordingly. A change in their mint par of exchange affects their market rate of exchange immediately. Consequently the mint par of exchange and market exchange rate between two such countries continually fluctuate from one ratio to the other.

(d) If the mint par of exchange between two countries does not depend upon the relation of the intrinsic values of their standard moneys; but upon the metallic values of the standard moneys of the two countries statutorily promised as is the case in gold bullion standard, gold exchange standard, etc.; the mint par of exchange between two such countries changes as soon as there is made any change in the statutorily promised quantity of bullion against the standard money of either of the country or both the countries, unless the change made is in exact proportion to the previous ratio or the mint par, and in case the change is not proportionate and the mint par of exchange between them changes, it at once affects the market rate of exchange between the two countries. Further it should be noted here that if the standard money of a country is made of silver, but its external value is fixed in terms of currency of any foreign country under a statutory obligation or executive policy of the government as has been the case of India's mint par of exchange with England, every change in this officially fixed mint par of exchange affects the market rate of exchange. It should be noted here that control of foreign exchange rates through such a mint par of exchange is a very weak one, and in the history of Indian foreign exchange there are many instances of the

failure of this machinery. The chief reason of the failure of this system is its inherent weakness due to the artificiality of the system. In this system so long as the economic conditions of a country follow the same old monotonous routine of normality the system works suitably, but the moment there is any extraordinary commercial or industrial boom or depression the machinery collapses, and is not able to control exchange rates: with the result that sudden and steep changes in the exchange rates sometimes bring disastrous consequences to the industrial and commercial class of persons and extreme trouble to the general public.

(s) A fifth factor which affects the rates of exchange of a country with others by affecting her mint par of exchange is the condition of her paper currency. If paper currency of a country is easily convertible and in exchange of it standard coins or specie can easily and quickly be secured at its face value, the mint par of exchange of that country are true and are able to control the market exchange rates within their respective specie points. On the other hand if the paper currency of a country is not easily convertible and there is a difference in the values of the official standard and the market standard such as is the case in England since September 21, 1931, when it went off gold standard, then the real mint par of exchange of such a country with another becomes a different one than originally fixed, and can be determined by finding out the total amount of paper currency of the country which will buy in the country that quantity of pure gold or silver which is contained in a unit of standard money of the foreign country, which is used to express the above mint par of exchange. For example after the Great War of 1914-18 Germany inflated her paper currency to such an extent that it became extremely inconvertible. The result was that there came in a great disparity between a paper mark and a gold mark. Consequently the mint par of exchange of Germany changed to unprecedented levels and the German exchange rates became highly unfavourable to Germany and favourable to other countries.

On September 21, 1931, England also went off gold

standard *i e.*, there came in a disparity between the values of a gold and paper pound, with the result that mint pars of exchange of England changed against England and the English exchange rates also followed suit. In course of time many other countries of the world also either went off gold standard or devalued their standard moneys. The result is that at present foreign exchange rates of most of the countries of the world do not depend upon the relation of the metallic contents of their standard moneys, but upon the extent of depreciation of their paper currency or devaluation of their standard moneys. Thus we see that the foreign exchange rates of a country are also affected by depreciation of her paper currency owing to its undue inflation.

(f) A sixth factor which affects the foreign exchange rates of a country by affecting her various specie points is the customs-tax or embargo on the export or import of specie from or into that country. In case the export or import of specie is prohibited, the specie points originally fixed become useless, and market rates of exchange may go to any extent either side according to the demand and supply of bills of foreign currency, for there remains no more an effective machinery to control them. On the other hand if the export or import of specie is not prohibited but discouraged by the levy of a customs duty, then the specie points of that country's exchange rates are widened further, for this tax becomes an item of additional expense in the transport of specie from or into that country. Consequently the market rates of exchange get wider range for movement from one direction to the other. Similarly other factors that give a wider field to an exchange rate to move from one direction to the other according to the supply and demand of bills of foreign currency are the expenses of transport of specie from one country to the other such as shipping freight, insurance premium, etc. Variations in the amounts of these items of expense change the specie points that control the market rate of exchange. Consequently exchange rate between two countries is also affected by changes in the above items.

(2) Conditions that affect the demand and supply of bills

Conditions that affect the balance of indebtedness between two countries and through that the demand and supply of bills or foreign currency are as follows —

(a) *Trade Conditions* The market rate of exchange of a country with another depends upon the demand and supply of bills of that foreign country into that country. Bills are drawn for the value of goods exported. Thus if a country has exported more goods to another than it has imported from that, the supply of foreign bills at that time into that country will be larger than their demand. Consequently competition on the side of suppliers of foreign bills or currency will be larger than the competition on the side of importers of foreign goods who make a demand of those foreign bills. Therefore people will offer a lower price for those bills or foreign currency. The exchange rate as such will have a tendency to become in favour of the country; i.e. the same unit of home currency will exchange for more of foreign currency, or for the same unit of foreign currency purchasers will offer less of home currency. But the limit beyond which the exchange rate will not fall is that gold or specie point beyond which it will be advantageous for the holders of foreign bills or the exporters to ask their foreign debtors to export gold or specie to them at their cost.

On the other hand if at any time a country has imported more goods from a foreign country than her exports to it the demand of foreign currency or bills will be larger than their supply. Consequently the price of foreign bills into that country will have a tendency of rising. The same unit of home currency will begin to exchange for less of foreign currency or the same unit of foreign currency will begin to exchange for more of home currency. The exchange rate will tend to become favourable to the foreign country and unfavourable to that country which has imported more. But here also the limit beyond which the exchange rate will not rise or the price of foreign currency in terms of home currency

will not go is that specie or gold point beyond which it would be advantageous for the debtors or importers to make the foreign payment by exporting gold or specie rather than purchase a foreign bill. Thus we see that exports and imports of goods including bullion from and into a country affect her foreign exchange rates.

The difference between the total exports and imports of a country for a time is said to be its balance of trade. It is said to be in favour of a country when her exports are larger than her imports. On the other hand if imports exceed the exports the balance is said to be against the country. Thus excess of exports over imports of a country gives her favourable or strong exchanges. On the other hand excess of imports over exports of a country gives her an unfavourable balance of trade and with that unfavourable or weak exchanges. Generally India has a favourable balance of trade. Out of every ten years India has a favourable balance of trade in nine. Consequently generally Indian exchange rates have a tendency to be in favour of the country.

It should be noted that the foreign exchange rate between two countries at any time depends not only upon their mutual trade conditions and balance of indebtedness arising therefrom, but that it is also affected by the intervention of a third country. Suppose for instance that at any time India has imported more goods from Japan than it has exported to it, but at the same time it has exported more goods to China than it has imported from that country. In this instance India may draw upon her credit balances in China in order to pay off her debts to Japan. If this is done the exchange rate between India and Japan will not be so adversely affected by their trade conditions, but there is no doubt that exchange rate between China and Japan shall be affected by them all the more and shall have the tendency of becoming in favour of Japan and against China. Thus it becomes clear that a country's foreign exchange rates with the other countries of the world do not depend upon her trade relations with every other country separately, but upon the exports and

imports of that country to and from other countries of the world as a whole or on her total balance of trade

Exports and imports of merchandise which affect the foreign exchange rates of a country also include the exports and imports of bullion or specie for they also affect the demand and supply of foreign bills in the same manner as the ordinary trade goods. Ordinarily gold or specie is not imported into a country unless her exchange rate becomes so favourable against another country that it becomes possible for her people to get gold from that foreign country at a price cheaper than the price at which it can be obtained inside the country. This is generally the case when the exchange rate if quoted in terms of foreign currency crosses the limit of the maximum specie point. Similarly gold or specie is not exported from a country unless her exchange rate becomes so much against it that payment by exporting gold or specie becomes cheaper than by purchasing a foreign bill. This is generally the case when the exchange rate if quoted in terms of foreign currency crosses the limit of the minimum specie or gold point. For example before England had gone off gold standard India used to import gold whenever the Indian exchange rate crossed the limit of 1s 6 3/16d maximum specie point. On the other hand it used to export gold whenever her exchange rate fell below 1s 5 49/64d the minimum specie or gold point. Except during the period of world economic crisis and trade depression which affected Indian economy with a very severe force from 1931-32 India used to have very heavy favourable balances of trade. Consequently in those days her exchange rate rarely fell below the minimum specie point necessitating the export of gold. In those days India usually imported large quantities of gold from other countries specially England. During the period of economic crisis and trade depression India's favourable balances of trade became extremely low and exports of gold from here were very large.

(b) *Invisible exports and imports* Foreign exchange rates of a country are affected by her exports and imports of mer-

chandise for they determine her balance of indebtedness and thereby influence the demand and supply of foreign bills into that country at that time. Besides these exports and imports of goods there may be various other items which may affect a country's balance of indebtedness *e.g.*, payments arising out of services rendered to or by the country with regard to the other countries of the world. Every year India has to pay a large amount to Great Britain by way of freight earned by British ships for the transport of goods to and from India to other countries of the world. Next, every year there is a huge amount of interest or profit earned by British capital invested in various trades and industries in India. Then there are salaries and pensions payable to Englishmen in Great Britain for services rendered to India by them either in India or in England, large amounts of yearly expenses of the Government of India in England for the recruitment and maintenance of English soldiers for the Indian armies, educational expenses of Indian students studying in various universities and colleges of Great Britain, expenses of Indians who go to England on business or pleasure trips, etc. All these debit items affect India's total indebtedness to England and through the demand of English bills influence her exchange rate with England.

On the other hand there are several items for which India has to receive payments from England *e.g.*, the expenses of English tourists in India, the expenses of the Government of India over the maintenance of Imperial Armies in India, etc. For the sake of convenience of expression in a combined form and to reflect the nature of their affect on the foreign exchange position of the country, these various items for which a country has to pay or receive payment from other countries are called her invisible imports and exports. Items for which a country has to pay to other countries are known as her invisible imports, while items for which a country has to receive payment from other countries are known as her invisible exports. Normally India has a big favourable balance of trade of her visible exports and imports, but the balance of indebtedness of her invisible exports and imports

is a very heavy unfavourable balance and it affects the foreign exchange rate of India with England very materially. Before the economic depression of 1931-35 generally the favourable balance of trade of India's visible exports and imports used to be about Rs 95 crores while the unfavourable balance of trade of India's invisible exports and imports used to be about Rs 50 crores. Thus on the whole normally India used to have a favourable balance of indebtedness of about Rs 45 crores, which used to be liquidated by the import of gold and silver. During the world economic depression India's exports of goods fell more heavily than her imports, and as such her favourable balance of trade of visible exports and imports dwindled very rapidly while the unfavourable balance of her invisible exports and imports was more or less the same as before. Consequently from 1931-32 to 1939-40 India exported large quantities of gold to maintain her exchange rates.

(c) A third factor that affects the foreign exchange rates of a country by influencing the balance of indebtedness which is in course of being paid consists of stock exchange operations. Shares and debentures of some of the important companies of the different countries of the world are such that they are readily sold and purchased in the different stock exchanges of the world. These securities are known as international stocks and variations in prices of these stocks at different centres result in orders to buy or sell being sent from one centre to another. Dealings in these stocks are genuine as well as speculative. Whatever be the nature of these dealings they affect the demand and supply of foreign bills or currencies of the countries whose people take part in these international dealings and as such affect their foreign exchange rates. Between different important stock exchanges of the world such as New York, London, Paris, Berlin, Bombay, Calcutta, etc., there are always international accounts running as a result of these dealings and their settlement affects exchange rates.

Similarly sometimes the attraction of cheap money in

some foreign country tempts the people of a country to float their loans into that foreign country. A loan may be floated by a private company or the government of a country. A loan may be floated either in terms of home currency or in the currency of that foreign country. If a loan is floated in a foreign country in terms of foreign currency, it increases for the time being the supply of foreign bills or currency in the borrowing country and as such affects her foreign exchange rate by making the foreign currency cheaper in terms of home currency. On the other hand if a loan is floated in a foreign country in terms of borrower's currency, it increases the demand of that currency in the foreign country, which is the same as saying that the supply of foreign currency inside the debtor country increases. Consequently the result of both the above arrangements on the foreign exchange rate of a country is the same. The price of currency of borrower's country in the foreign land increases or the price of foreign currency in the debtor country falls. This is generally the way in which the foreign exchange rate of a country is affected at the time a loan is floated.

On the other hand at the time of repayment of a foreign loan or the payment of interest or profit accrued thereon from time to time, the foreign exchange rate of the debtor country is adversely affected for then the demand of foreign currency inside the debtor country increases, and as such other things remaining the same, the price of foreign currency in terms of currency of the debtor country rises. It should be noted that at a time of exchange weakness such credits of a country in foreign lands help her to maintain her exchange rates by liquidating those credits. Such loans are very often raised in important financial centres of the world such as London, New York, etc., where money rates are generally low. The Government of India very often floated such loans in the London Money Market. Moreover some of the industrial and commercial companies in India have also from time to time floated such loans in the London Money Market. Before the present world war the total amount of such capital borrow-

ings of India both on Government and private account was about Rs 778 crores

(d) A fourth factor that affects the foreign exchange rates of a country consists of the operations of her exchange banks. These banks have branches in different countries of the world and finance their foreign trade by their exchange operations. They buy and sell foreign bills. If a country quotes its exchange rate with regard to another in terms of its home currency such as India quotes Japan Rs 76 7/8 per 100 yens exchange banks purchase exchange or foreign bills at low rates and sell at high rates. On the other hand if a country quotes its exchange rate with another in terms of foreign currency such as India quotes England Rs 1/ per 1s 6d exchange banks purchase exchange or foreign bills at high rates and sell them at low rates. By doing this business they make a profit for themselves. Even if a bank expects that there will be no variation in the foreign exchange rate between two countries it may discount a long period bill and hold it till maturity and recoup its advance by selling a short period bill. This is done by banks to make a profit by investing their funds in such short period self liquidating securities. Thus a bank may buy or sell foreign exchange in order to take advantage of differences in exchange rates at different times or the differences in buying and selling rates at the same time or in order to earn interest by investing its short period funds in the form of discounting foreign bills.

In order to take advantage of different exchange rates at different times banks buy and sell forward exchanges or foreign bills that mature after several months from the date of their purchase or sale. In order to protect themselves from losses which may arise due to fluctuations in exchange rates businessmen also prefer to enter into a forward exchange purchase or sale agreement with an exchange bank. Sometimes exchange banks also transfer their funds from one country to another through their various branches in order to take advantage of different rates of interest prevailing in the different countries at the same time. Funds

are transferred from the various branches of that country or countries where the rates of interest are low to the branches of that country or countries where interest rates are high. All these activities of exchange banks also affect the exchange rates of a country by increasing the demand or supply of foreign bills into that country.

Another way in which banks as well as other persons may affect the exchange rates of a country are their arbitrage operations. Arbitrage is the name given to that type of speculation which arises out of the difference in prices of the same commodity at different centres at the same time. For example suppose the exchange rate between India and England is quoted in Indian exchange market as 1s. 6d. while in England it is quoted at the same time as 1s. 6 $\frac{1}{8}$ d. per rupee. *In order to take advantage of this difference of $\frac{1}{8}$ d. per rupee, a bank or a person who has a branch or correspondent in India will draw a number of rupee bills in England upon his Indian branch or correspondent and sell them at 1s. 6 $\frac{1}{8}$ d. per rupee. At the same time he will ask his Indian correspondent to draw on him an equal amount of sterling bills and sell them here in India at the rate of 1s. 6d. per rupee. Thus these bills will cancel each other and the parties will make a profit of $\frac{1}{8}$ d. per rupee on their deal, which they can share between themselves. This is known as an arbitrage operation in foreign exchange.*

If in an arbitrage operation only two countries are involved the arbitrage is said to be a simple one. On the other hand if several countries are involved in an arbitrage operation and the advantage of difference in exchange rates is taken in a circuitous method, the arbitrage is said to be a circuitous one. For example suppose at any time the following exchange rates prevail in the exchange markets of India, England and France :—

India. ✓	England.	France.
1s. 6d. per rupee.	1s. 6d. per rupee.	70 francs per
542 francs per	70 francs per £	542 francs per
Rs. 100/-.		Rs. 100/-.

From the above quotations it is evident that sterling pound is cheaper in France than in India. Thus if an Indian may purchase sterling in India for Rs 100, he will get £ $7\frac{1}{2}$. On the other hand if he may purchase sterling pound through France, he will be able to purchase 542 francs in France with his Rs 100, and then with these 542 francs in France he can purchase £ $542/70$ payable in England. Thus with his Rs 100 he is able to purchase in England through France £ $542/70$ minus $15/2$ or £ $17/70$ more. This amount converted into rupees at 1s 6d. exchange rate prevailing then between India and England will give to the Indian dealer a profit of Rs $3/3/9 \frac{5}{7}$ per arbitrage deal of Rs 100. This is known as a circuitous exchange arbitrage operation. All these arbitrage operations whether simple or circuitous affect the demand or supply of foreign bills or currencies, and as such affect the foreign exchange rates.

Balance of Trade Theory

In the foregoing pages we have studied the different factors on which the market rates of exchange of any country at any time depend. It is clear from those pages that the price of foreign bills or the market rates of exchange of any country at any time depend upon the demand and supply of foreign bills which on their turn depend upon the various items for which a country has to pay to other countries and the various items for which a country has to receive payment from other countries or the balance of indebtedness. Among all the items for which a country has to receive payment from other countries or has to make payment to other countries of the world, generally foreign trade conditions or exports and imports play the most dominant part and exchange bills are mostly drawn or demanded in response to these trade conditions. Consequently the exchange rates of a country are determined mostly by her foreign trade conditions i.e., the exports and imports of goods or the balance of trade. If a country has exported more to other countries than what it has imported from them or has a favourable balance of trade then generally it shall have a

larger supply of foreign bills than their demand, and as such its exchange rates shall become favourable to it. On the other hand if a country has imported more from other countries than what it has exported to them or has an unfavourable balance of trade, then generally it shall have a larger demand of foreign bills or currencies than their supply, and as such its exchange rates shall become unfavourable to it. Thus we see that the exchange rates of a country depend mostly upon its balance of trade, and this is commonly known as the *Balance of Trade Theory of Foreign Exchange Rates*.

Kinds of Exchange Rates

In the foreign exchange market of a country sometimes several exchange rates are quoted for the same foreign country. Foreign exchange rates are generally the prices of foreign bills. Bills are of various kinds. Some are payable on demand or at sight while others are payable after some time—several days or months. Thus in the case of some foreign bills foreign currency can be obtained by the purchaser or his agent immediately after the purchase of the bill, while in the case of others the purchaser is able to obtain the foreign currency purchased after some time—one, two, three, four or six months. Payment for both the kinds of bills has to be made immediately after the purchase. Consequently in the case of prices of bills of the former type or their exchange rates, there is no element of interest. On the other hand prices of bills of the latter type or their exchange rates have an allowance of the loss of interest to the purchaser for the period commencing from the date of the purchase of the bill till the date of its final payment. Thus if a country quotes her exchange rate with some foreign country in terms of the currency of that foreign country, the exchange rate becomes higher as the tenor of the bills becomes longer. On the other hand if exchange quotation is given in terms of home currency, the longer is the tenor of the bill the lower becomes its exchange rate.

In this connection it must be noted that the interest which

influences the prices of different kinds of bills of a foreign country in another (commonly known as short and long exchanges) is the rate that prevails at that particular time in that foreign country the prices of whose bills are quoted in the other. This is due to the fact that by purchasing a foreign bill of exchange, money becomes available to the purchaser sooner or later in that foreign country and not in his home country. Below are given the exchange rates of different kinds of short and long period English bills commonly quoted in the Indian exchange market :—

T.T Ready	1s. 6 3/32d.	} Short exchanges.
On Demand	1s. 6 1/8d.	
D.A. 3 m/s	1s. 6 7/32d.	} Long exchanges.
D.A. 4 m/s	1s. 6 1/4d.	
D.A. 6 m/s	1s. 6 5/16d.	
D.P. 3 m/s	1s. 6 7/32d.	
D.P. 6 m/s	1s. 6 5/16d.	

T. T. or *T/T* means telegraphic transfer. In this case advice for the payment to the agent of the purchaser is sent to the foreign country by the seller by means of a cablegram. Hence it is called telegraphic transfer. The price is paid here by the purchaser in Indian currency immediately on the purchase of the transfer and foreign currency is made available to him in England within about 24 hours, or the time that the cablegram takes in reaching London. Thus here practically there is no loss of interest.

On Demand: These are foreign bills drawn payable on demand, on presentation, or at sight. Consequently the exchange rate of these bills is also called the cheque rate. In this case the purchaser pays the price here according to the rate at the time of purchasing the bill. After purchasing the bill, he may send it to his creditor in England by ordinary post or by air-mail. The receiver in England can obtain the payment immediately on its presentation to the drawee in his country. In this case some time is lost in sending the bill from India to England, hence the exchange rate con-

tains a small fraction by way of interest allowed to the purchaser.

"*D.A. or D.P. 3, 4, or 6 m/s.*" These are bills payable in the foreign country (in the previous example London) after 3, 4, or 5 months respectively from the date of their being accepted or sighted by the drawee. In addition to the above periods some time is lost in sending the bill from India to England. Thus the purchaser of such a bill in India is able to get foreign currency in England after the tenor provided in the bill plus the time taken by it in transit from India to England and in being sighted by the drawee. Thus these bills are not as good as telegraphic transfers or bills payable on demand, for in their case a good deal of time is lost between the date of paying their purchase price in India and receiving payment thereof in England. Consequently these are generally called long bills and the rates at which they sell are called 'long exchanges', whereas the bills of the former type are called short bills and the prices at which they sell in the market are called 'short exchanges'. Thus in respect of time short bills are better than the long ones, and as such the prices of different kinds of bills or their exchange rates differ according to various tenors of those bills. The shorter is the tenor of a bill the higher is the price of it, whereas the longer is the tenor of a bill the lower is its price. Thus telegraphic transfers are the costliest. If a country quotes foreign exchange of some other country in terms of foreign currency such as India quotes England in terms of English currency, the rate for the telegraphic transfers is the smallest, whereas of others rates increase according to the longevity of the tenor. On the other hand if a country quotes foreign exchange of some other country in terms of her home currency the telegraphic transfer rate would be the highest, and of others rates would fall according to the longevity of the tenor.

It has been mentioned before that the prices of different foreign bills short and long differ according to their tenor. The difference between their prices or rates represents interest on the amount of foreign currency purchased for the

period commencing *from the date of purchase* to the time of receiving payment in that foreign country. This interest is determined at the rate prevailing in the foreign market where the bill is made payable and not according to the rate prevailing in the home money market. The reason of this is that if actually money is required in the foreign country after a certain time, the choice is either to purchase a telegraphic transfer and then earn interest on its amount in the foreign country by investing it for the time it is not required at the rate prevailing there, or to purchase a long period bill and thus get money in the foreign country at the time when it is actually required. On the other hand in case a person has to make a payment in the foreign country immediately, he can either purchase a telegraphic transfer and make the payment at once, or purchase a long period foreign bill and obtain cash in the foreign country immediately by discounting it at the then discount rate prevailing there and then make the payment. Thus in both the cases of immediate and deferred payments the rate of interest of the foreign market where the different bills are made payable influences the difference in their prices or exchange rates.

An argument that may be advanced against these arrangements is that a person in India who has to make a payment to an Englishman after some time and not immediately may be influenced by the high rate of interest in the home market and as such unless he gets the long period bill at a reasonable price determined by the home market rate of interest, he may postpone the purchase of a foreign bill until and unless the time of payment has actually come and when that time actually comes he may purchase a telegraphic transfer and make the payment. There is no doubt that such an alternative is available to an Indian debtor, but it must be noted here that by doing so the Indian debtor shall take the risk of fluctuations of exchange rate upon himself and in case he is prepared to take this risk (which is generally not the case) he can do so. This shows that the difference in prices of different kinds of foreign bills—short

and long period bills depends more on the rate of interest prevailing in the foreign market where they are made payable, though that may be slightly influenced also by the rate of interest prevailing in the market where they are offered for sale.

Tel quale or tel quel exchange rate. It has already been mentioned before that generally exchange rates between two countries are quoted for two kinds of bills—short and long bills. Long bills may be of one, two, three, four, or six months. Prices or rates of long period bills also contain an allowance of interest for the time provided in the bill. When a bill is actually under sale, it is sometimes found that the number of days that it has to run before maturity does not exactly correspond with the number of days provided as tenor in that bill. The reason for this is that in the case of that bill some period of its tenor has already expired. The exchange rate of such a bill differs from the rate of bills of similar tenor out of which no period has as yet expired and the bills have to run their full tenor in order to mature and become payable. The price or exchange rate of bills of which some portion of the tenor has already expired before sale is technically known as the 'tel quel rate'. For example suppose a person in India offers for sale a bill of £ 10/- which was originally drawn payable after 3 months, but from the date of sale now it has only $2\frac{1}{2}$ months left to mature, the rate for three months bills is 1s. 6 $\frac{1}{4}$ d. per rupee and the bank rate in London is 4%. The price of this bill will be ascertained as shown below :—

The basis of calculation is 3 months rate which is 1s. 6 $\frac{1}{4}$ d. per rupee.

At 1s. 6 $\frac{1}{4}$ d. three months rate £ 10 are equal to Rs. 131'5

Interest at 4 % for $\frac{1}{2}$ month on Rs. 131'5 = Re. 0'22

∴ the price offered for £ 10 bill originally payable 3 months after, but now payable after $2\frac{1}{2}$ months will be Rs. 131'5 plus Re. 0'22 or Rs. 131'72.

Therefore the rate of exchange at which this bill will be offered for sale will be :—

Rs. 131'72 are equal to £ 10/-.

Therefore Rs. 1/- is equal to $1s. 6 \frac{726}{3293}d.$ —the tel quel exchange rate of the above bill.

It should be noted here that in case the basis of calculation taken is the exchange rate of any bill shorter than $2\frac{1}{2}$ months duration, interest amount instead of being added shall be deducted in the above calculation and thus the tel quel rate of the bill which has $2\frac{1}{2}$ months as yet to run shall be calculated. For example:—

£ 10/- payable after $2\frac{1}{2}$ months.

At $1s. 6 \frac{1}{8}d.$ one month rate £ 10 are equal to Rs. A.

Minus interest at 4% for $1\frac{1}{2}$ month = Rs. B.

Therefore the price offered for £ 10 bill will be Rs. A minus B.

Therefore the tel quel exchange rate will be:—

Rs. (A minus B) is equal to £ 10.

or Rs. 1/- is equal to £ 10/- divided by (A minus B).

Thus a tel quel exchange rate of a bill is the rate of that bill calculated on the basis of the rate of a long or short period bill in order to correspond to the term of the bill which that particular bill has still left to run in order to mature. Generally this rate is calculated in order to find out the exact price of a tenor bill on a particular date in order to facilitate the business of sale or purchase of exchange without the loss of interest to any party.

Questions

1. What is meant by market rate of exchange? How is it determined between any two countries? Explain.
2. What are specie points? How do they control the market rate of exchange between two countries? Explain.
3. Trace the relation between the favourable balance of trade of a country and her foreign exchange rates.
4. "Generally favourable exchange rates of a country are beneficial to its consumers and harmful to its producers." Comment on this statement.

5. Describe briefly the different factors which affect the market rates of exchange of a country.

6. What do you understand from the invisible exports and imports of a country? How do they affect the exchange rate of a country? Explain.

7. What is Balance of Trade Theory of foreign exchange rates? Explain the theory and point out its limitations, if any.

8. What do you understand from short and long exchanges? Which of the two are cheaper and why? Explain.

9. Write short notes on:—

(a) T.T.,

(b) D.R. 3 m/s.,

(c) Telegraphic exchange rate.

CHAPTER XVII

RATIO CONTROVERSY

In the foregoing pages we have studied that the external exchange values of Indian standard or India's mint par of exchange with England and through that with the other countries of the world have been different at different times. Naturally a question that arises is what is the correct or proper external exchange value of the standard money of a country. Technically this is known as the normal rate of exchange and in a general way it is defined as "one which prevails in, and brings about conditions of equilibrium in the balance of payments and of general economic stability. This rate imposes no strain either on the balance of payments or on export industries; causes, consequently, no continuous outflow or inflow of gold; subjects the internal economy of a country to no undue stress and reflects the basic economic relations, including the relations of price levels, of one country and another."¹ Fixing the mint par of exchange of any country at a rate higher than the normal rate when that mint par is fixed in terms of foreign currency is technically called over-valuation. On the other hand fixing the mint par of exchange of any country at a rate lower than the

¹History and Problems of Indian Currency by D. K. Malhotra, page 8.

normal rate, when that mint par is fixed in terms of foreign currency is technically called undervaluation. Both overvaluation and under-valuation of a country's standard in terms of other foreign currencies indicate abnormal mint par of her foreign exchange.

Devaluation is also a technical currency term and is applied to the process of a deliberate attempt to reduce the external exchange value or purchasing power of the standard money of a country by decreasing statutorily the quantity of gold or foreign currency into which that standard money is changeable in the foreign exchange market. Thus devaluation is a deliberate step towards reduction of the external value of the standard money of a country undertaken either with the object of correcting the wrongs of an over valuation or to secure certain temporary advantages of an under-valuation. An over-valued currency discourages exports and export industries and encourages imports with the result that the normal balance of payments of the country is upset and exports of capital and gold are stimulated. On the other hand an under valued currency discourages imports, encourages exports and export industries with the result that the balance of payments of the country tends to become favourable and imports of capital and gold are stimulated. It must not be overlooked here, that both over-valuation and under-valuation cause only temporary dislocations in the relative price-levels or parity of two countries and in course of time the old or normal purchasing power parity again gets established in them, and the temporary disadvantage or advantage of over or under valuation of the mint par of exchange disappears.

In India the problem of the standard and its external value or the mint par or par of exchange is an old one. It dates as far back as 1893 when India gave up the silver standard and free coinage of rupee. Truly speaking this ratio controversy is due to the artificiality of the Indian currency standard contained in gold exchange standard and sterling exchange standard systems adopted by this country.

from time to time. In 1893 the Fowler Committee recommended and the Govt. of India accepted 1s. 4d. as India's mint par of exchange with England though the real gold value of the silver contents of the rupee was then much less than 1s. 4d. and even the exchange value of the rupee due to its scarcity in circulation was a little less than 1s. 4d. or about 15'9d. Then during the period of the Great War of 1914—18 owing to great rise of the price of silver coupled with a continuous favourable net balance off oreign trade Indian exchange rate rose higher from year to year. In 1920 the Babington Smith Committee emphasized the importance of a stable exchange rate and fixed India's mint par of exchange with England at 2s. gold or 2s. 4d. sterling to a rupee. It should be noted here that in spite of a high price of silver at that time the real value of the metallic contents of the silver rupee was not 2s. gold or 2s. 4d. sterling, but the Committee recommended an over-valuation of Indian mint par of exchange on the following grounds:—

(1) Over-valuation would make the rupee a token coin and that would ensure the working of the Gold Exchange Standard as before.

(2) A high mint par of exchange would enable the country to obtain imports of goods at lower prices, while her exports would not be affected adversely for there was a great world demand for Indian raw materials and food-stuffs.

(3) High mint par of exchange would help the Indian industries by enabling them to import foreign machinery and stores at lower costs, and by maintaining the cost of living of labourers low would prevent any rise in their wages.

(4) High mint par of exchange would enable the Government of India to pay off Home Charges with a smaller number of rupees.

Mr. D. N. Dalal a member of the Babington Smith Committee was opposed to the over-valuation of the rupee and fixing India's mint par of exchange at 2s. gold or 2s. 4d. sterling. He was in favour of going back to the old rate of

1s. 4d. for he held that the then high price of silver was due to artificial reasons. He opined that a high exchange would harm Indian industries and exporters very much and at the same time cause enormous losses to the Government of India, for her sterling holdings when converted into Indian currency at the new rate of exchange, would depreciate tremendously. In spite of Mr. Dalal's minute of dissent to the Committee's report containing a very timely warning and an opposition in the country, the Government of India fixed the Indian mint par of exchange with England at 2s gold or 2s. 4d. sterling per rupee through various notifications and the Indian Coinage Amendment Act of 1920. From June 1920 there arose a very great demand of sterling in India on account of a fall in exports and a great rise in imports. The unfavourable balance of India's foreign trade of that time was accompanied by a fall in the price of silver in the world markets. Both of these factors combined to threaten the stability of the newly established Indian mint par of exchange.

The Government of India took steps to prevent the fall of India's exchange rate and maintain it at the rate of 2s gold or 2s. 4d. sterling by offering Reverse Council Bills at rates based on the new parity or mint par. Despite efforts of the Government of India to maintain Indian exchange at the new parity, it began to fall and the fall was further accentuated by the deflationary policy of the British Government which wanted to come back to gold standard. Government of India's attempts to maintain India's exchange at the new high parity by selling Reverse Councils at the new rates and by contracting the volume of currency in circulation caused tremendous losses both to the Government and the businessmen. 'The loss to the Indian exchequer caused by the ill-advised attempts to maintain the rupee at 2s. amounted to Rs 40 crores'¹ Merchants in India who had ordered goods from England in the hope that they would pay for them at

¹History and Problems of Indian Currency by D K Malhotra, page 45.

the rate of 2s. per rupee, suffered very heavy losses for the Government could not maintain the fixed rate and by December 1920 it fell down to the low level of about 1s 5d. per rupee. In March 1921 the Indian exchange rate fell still lower to 1s. 2 $\frac{1}{2}$ d. sterling or under 1s. gold. From 1922 to June 1925 Indian exchange rate recovered and came upto the level of 1s. 6d. gold, and any further rise in it was prevented by the Government of India by introducing the practice of purchase of sterling bills in India at the rate of about 1s. 6d. per rupee.

In April 1925 England returned back to gold standard and in August of that year was appointed the Hilton Young Currency Commission. In 1926 the Commission gave its report and majority of its members recommended 1s. 6d. per rupee as India's mint par of exchange with England and gave the following arguments in its favour :—

(1) The present market rate is about 1s. 6d. It has been at that level in relation to gold since June, 1925, and in relation to sterling since October, 1924.

(2) At the present exchange rate of about 1s. 6d., prices in India have already attained a substantial measure of adjustment with those in the world at large, and, any change in the rate would mean a difficult period of readjustment, involving wide spread economic disturbance.

(3) The commission did not believe that there was then any maladjustment in wages either of agricultural or of manufacturing industries. They admitted that certain important industries of the country were in a state of depression, notably the steel and cotton mill industries, but they asserted that relief in them could not be obtained by manipulation of the exchange rate.

(4) It is true that many of the current land revenue contracts were settled when exchange was 1s. 4d. ; but in view of the great rise in prices since 1914 the commission did not regard 1s. 6d. exchange rate a hardship in that respect. With regard to other long term contracts the commission

asserted that contracts and arrangements concluded prior to 1918 still existent were not in bulk larger than those concluded after 1918 when the exchange rate had broken away from 1s 4d. Moreover really most of the contracts were short-term obligations and not long term

On account of the above reasons the commission concluded that from the point of view of prices, wages and contracts, least disturbance would be caused and least injury would be done to all the interests concerned, by adhering to the *de facto* rate of 1s. 6d.

Commission's Arguments Against Reversion to 1s. 4d

(1) 1s. 4d. exchange rate has been advocated and described by many as the natural rate, but we have not been able to ascertain exactly what is meant by that term. Fluctuations in exchange are produced by the mutual interaction of internal and external prices, and as the level of internal prices is determined mainly by the volume of internal currency, the only rate which can properly be regarded as natural is the figure at which these prices are in adjustment with the existing volume of currency and are also in equilibrium with external prices. From this point of view 1s. 6d. appears to be clearly the natural rate under present conditions

(2) The commission did not agree with the view that in case of an adverse balance of trade, it would be more difficult to maintain exchange at 1s 6d. than 1s. 4d with the establishment of a central currency and banking authority, with full power to make its credit policy effective, provided that gold and gold securities reserves were sufficient to prevent their exhaustion before the necessary contraction of the rupee had been brought about.

(3) It had been suggested that competition from foreign countries with depreciated or depreciating currencies, such as France and Belgium, could be met by lowering the Indian exchange to 1s 4d. The commission contended that once

those currencies had been stabilised, the adoption by India of a ratio of 1s. 4d. rather than 1s. 6d. would not leave her in any better position to meet that competition.

(4) It had been suggested that if world prices fell in future 1s. 4d. rate would check a rapid fall of prices in India than 1s. 6d. rate, but the commission argued that in the near future no abnormal fall of prices was expected in the world and in case there was any prolonged fall of prices that would certainly react on Indian prices whether the exchange rate was 1s. 4d. or 1s. 6d.

(5) The commission contended that a reversion to 1s. 4d. would be beneficial to certain sections of the community *e.g.*, debtors, exporters, and employers of labour at the expense of certain other sections *e.g.*, creditors, importers, and wage earners and that too only temporarily during the period of adjustment and not to the country as a whole.

(6) 1s. 4d. exchange rate was not effective from 1917 to 1925 and it could not be contended that prices and wages in India in 1925 were adjusted to that ratio. The only rate at which there could be assumed any adjustment of prices and wages was the *de facto* rate of 1s. 6d. and as such reversion to 1s. 4d. rate would result in an arbitrary reduction of the real wages of labour.

(7) A reversion to 1s. 4d. rate would upset the finances of the Government of India by increasing the burden of payment of her sterling obligations and would lead to increases in both Central and Provincial taxation.

The Minute of Dissent

Sir Purshotamdas Thakurdas a member of the Hilton Young Currency Commission disagreed from the opinion of the majority of members of the Commission that 1s. 6d. was *de facto* exchange ratio at that time, and that prices, wages and costs in India had adjusted themselves to that ratio. He prepared a minute of dissent and recommended a reversion of Indian mint par of exchange to the old rate of 1s. 4d. His arguments against 1s. 6d. rate and in favour of a reversion to 1s. 4d. ratio are described here briefly :—

(1) In September 1924, the exchange rate was approximately 1s 4d gold and the Government of India could have stabilised the rupee at 1s. 4d gold at that time. The exchange rate 1s 6d. sterling till June 1925 and 1s. 6d. gold after that date had been reached by a contraction or undue limitation of expansion of currency and stringency of money in the Indian money market. The rupee was maintained at 1s. 6d only by deflation of currency by Rs 8 crores during April 1926, and by an offer by Government through the Imperial Bank of India to sell Reverse Councils at 1s 5½d. Thus Government deliberately rejected the opportunity of stabilising the rupee at its pre-War ratio of 1s 4d when reached.

(2) Since June 1925 when Indian exchange became 1s 6d prices in India had not adjusted to the new level of exchange. Though prices in India had fallen since June 1925, but that fall was more in sympathy with the fall of world prices rather than the result of an adjustment of Indian prices to the new higher parity of 1s. 6d. Thus the fall of prices in India as a result of a complete adjustment of rupee prices to 1s. 6d. exchange rate was yet to come. With the attempt of different countries going back to gold standard the world prices were expected to fall and undoubtedly to affect Indian prices. Thus Indian prices were to fall as a result of two causes and that heavy fall of prices was sure to hit Indian producers very adversely.

(3) Wages in India had not been adjusted to the new exchange rate of 1s 6d per rupee. So long as wages had not been adjusted to the new rate of 1s. 6d, the foreign exporters of goods also produced in India, shall enjoy a bounty of 12½ per cent and aggressively compete with Indian industries. Adjustment of wages in India to the new exchange parity of 1s. 6d. by lowering them would entail a long and bitter struggle between labour and capital, with consequent dislocations in the economic organisation of the country.

(4) The adoption of 1s- 6d. exchange rate would be injurious to the debtor class particularly agriculturist, who were already over burdened, by imposing on them a depreciation

of monetary value of their produce and holdings due to a fall of prices as a result of the higher exchange rate or in other words would increase the burden of their debts to the extent of $12\frac{1}{2}$ per cent.

Reversion to 1s. 4d. Rate

(1) The rupee should be stabilised at the rate which obtained for nearly 20 years, viz., 1s. 4d. to the rupee, for a country's standard of value should never be changed unless it is found absolutely unmaintainable, or unattainable after a fall. Had the 2s. ratio not been put on the Statute under the conditions of 1920, and had the 1s. 4d. ratio been left undisturbed, when the fall in world prices took place, the probability was that it would have been naturally reached once more. Reversion to 1s. 4d. rate would not mean a depreciation of the Indian standard, but an elimination of the attempt of an artificial appreciation of the rupee represented by 1s. 6d. rate.

(2) It is claimed that reversion to 1s. 4d. would mean a loss to the finances of the Government of India as against stabilisation at 1s. 6d., but the loss to Government in sterling remittances would be made up in other ways. In any case, the gain to Government would be at the expense of the producer who has to accept so many fewer rupees for the produce he has to sell.

(3) Reversion to 1s. 4d. would cause no hardship to those whose contracts were entered into before 1917 and they included the vast mass of agriculturists, who were notorious for their continuous borrowing which were rarely repaid.

(4) In times of an adverse balance of trade, 1s. 4d. exchange rate would cause depletion of the gold standard reserve more slowly than 1s. 6d., and India was a country liable to bad monsoons at intervals reducing her exports heavily for some time. Even granting that the Government of India had enough resources to support exchange in such an emergency at 1s. 6d., the question was whether it was necessary to fix a higher ratio which necessitated larger resources to maintain itself and thereby undertake a substantial risk.

(5) If the rupee was stabilised at 1s. 6d., instead of a reversion to 1s. 4d., there were grave dangers that India would be faced during the next few years with a disturbance in her economic organisation, the magnitude of which was not difficult to estimate but the consequences of which might not only hamper her economic development, but might even prove disastrous.

The Hilton Young Currency Commission Report recommending India's mint par of exchange at 1s. 6d. per rupee and the Minute of Dissent of Sir Purshotamdas Thakurdas advocating a reversion to 1s. 4d. per rupee was published in July 1926. After that date there grew a controversy in India with regard to 1s. 6d. or 1s. 4d. per rupee exchange parity. The Government of India through their Currency Act of 1927 enforced from 1st April 1927 1s. 6d. sterling exchange ratio, which at that time meant 1s. 6d. gold for England had come back to gold standard in April 1925. From April 1927 to September 1929 excepting a few short periods, Indian exchange constantly showed signs of weakness or a tendency towards a fall and the Government of India very frequently sold large amounts of treasury bills and contracted the volume of currency in circulation to maintain the exchange rate at the high level of 1s. 6d. fixed. From September 1929 there started a depression in world trade and India could not remain unaffected. The prices of both agricultural commodities and manufactured goods began to fall and the fall in the prices of agricultural commodities was much heavier than in the prices of manufactured goods. India being mainly an agricultural country and Indian exports being mostly of agricultural commodities, Indian exports fell down much more heavily than her imports. Further the Civil Disobedience Movement started in 1930 created a nervousness among investors of capital in India, who began to transfer their capital abroad particularly England. All these factors made Indian exchange definitely weak.

India's Index Numbers of Wholesale Prices, Exports, Imports, Balance of Trade, Net Import or Export of Bullion in Crores of Rupees.

Years	Index Nos. of Wholesale Prices with 1929 as base—100.	Exports of merchandise.	Imports of Merchandise.	Balance of Trade	Net Import or Export of Gold Coin & Bullion + Net Import.
1926-27	105'0	309	230	+ 79	+ 19'4
1927-28	105'0	329	247	+ 82	+ 18'1
1928-29	102'0	338	251	+ 87	+ 21'2
1929-30	100'0	318	239	+ 78	+ 14'22
1930-31	82'3	225	164	+ 61	+ 12'75

From the above table it would be clear that the first period of $2\frac{1}{2}$ years ending with September 1929 was without any serious difficulty. Though prices had an all round downward tendency, yet both exports and imports of India went on increasing. The country's favourable balances of trade and imports of gold coin and bullion were on a progressive scale. There was an all round prosperity and everybody seemed to be happy. At this time there came in collapses in the booms of stock exchanges of United Kingdom and U. S. A. They gave a great shock to the international trade activity of the world. The malady was aggravated by a continuous flow of gold into U. S. A. and France in payment of reparations or War debts as the result of the Treaty of Versailles. The situation became all the more serious of the reason that U. S. A., the chief creditor nation of the world became also the principal manufacturing and exporting country. Thus the only way open to the various debtor countries of the world to make payment of their debts or reparation instalments came to be to export gold to U. S. A., France, etc. This could not be maintained and therefore it dis-

organised the currency and trade conditions of the world. Debtor countries could not meet their foreign obligations on the due dates. Consequently public confidence was shaken, credit curtailed, currencies depreciated and prices declined heavily. The result was that total international trade which was about Rs 19 000 crores in 1929 came down to about Rs 7,738 crores in 1932.

The Following Table Shows the Fall in the Export and Import Trades of the Various Important Countries of the World

Country	Year	Foreign Trade per head of population. Rs.	Total Foreign Trade (Rs. Crores).	Percentage of World's Total Foreign Trade.	Percentage Decline in Total Foreign Trade as compared to 1929.	Total Exports (Rs. Crores)	Percentage Decline in Exports as compared to 1929.	Total Imports (Rs. Crores)	Percentage Decline in Imports as compared to 1929.	Balance of Trade - Favourable + Unfavourable
India	1929 1932-33	17 7.6	584 269	3.1	53.9	331 136	58.9	253 133	47.4	+78 +3
U.K.	1929 1932	597 324	2747 1495	13.2	45.5	1119 555	50.4	1628 937	42.4	-509 -382.11
U.S.A.	1929 1931-32	214 84	2653 1011	13.9	61.9	1449 531	63.4	1204 480	60.1	+245 +51
Canada	1929 1932	920 304	957 316	3.5	67.0	496 155	68.7	461 161	65.1	+35 -6
Germany	1929 1932	296 105	1866 680	9.1	63.5	951 375	60.6	915 305	66.7	+36 +70
France	1929 1932	284 127	1165 531	6.2	54.4	539 211	60.7	626 320	48.9	+87 -109
Japan	1929 1931	90 47	595 318	2.9	46.6	300 153	49.0	295 165	44.1	+5 -12

The previous table shows that during the slump of 1929-32 almost all the countries lost heavily in their export and import trades and their total foreign trade came to occupy an abnormally depressed condition. The country which was very seriously affected was Great Britain. Before that trade depression London used to be regarded as the centre of world's international trade and finance. Generally people engaged in foreign trade tried to maintain a credit balance in London. But since 1920 Great Britain's balance of trade had begun to decline and demand of products usually exported from that country was falling. During 1928-30 the excess of her imports over exports increased to £ 30 millions. The invisible items also showed a loss of about £ 65 millions during this period. Thus the net credit balance of the country's external transactions showed a diminution of £ 95 millions and for the first time in its history in 1931 the country was faced with the difficulty of an adverse balance of payments amounting to £ 113 millions. Rumours of this as well as a large deficit of about £ 120 millions in the country's budget led to heavy withdrawals of foreign funds invested into that country.

France, Germany, Belgium, Switzerland, etc., started withdrawing their floating balances from London. These withdrawals became so quick and heavy that within 4 days from Sept. 16, to September 19, 1931, £ 43 millions of short-term funds were withdrawn, and the gold reserve of the Bank of England fell down to the extremely low figure of £ 13 millions. The effect of all these factors was that in spite of great efforts both by the Government of Great Britain and the Bank of England, the country departed from its gold basis and became off gold standard. In course of time many other countries of the world also went off gold standard. India also followed suit. On September 24, 1931 the Ordinance No. VII of the Government of India announced linking of the rupee to paper sterling at the rate of 1s. 6d instead of gold which was the position till September 21, 1931, and in the same position it was handed over to the Reserve Bank of India on April 1, 1935 with obligation to maintain the

rupée's external value between ls. $6\frac{3}{16}$ d. and ls. $5\frac{49}{64}$ d. upper and lower specie points.

The effect of England's going off gold standard was that except India sterling became depreciated or cheaper in terms of currencies of other countries of the world. Like England many other countries such as Canada, U. S. A., Japan, New Zealand, Denmark, etc., officially suspended the gold standard. To overcome these currency and exchange crises and slump in international trade and to arrive at an international currency and exchange agreement a world economic and monetary conference was held at London in 1933, but due to some conflicting political and economic interests of various countries it failed. Thus the different countries were compelled to find a solution of their difficulties by their own individual national efforts. The debtor nations' inability to pay in gold and creditor nations' insistence to receive their payments in gold in order to conserve or increase their stock of it led the various countries to discourage their imports and encourage the production and exports of both their agricultural and manufactured goods.

The following chart shows the dates of official suspension of gold standard, the percentages of depreciation of currency systems, the index numbers of wholesale prices, exports and imports of merchandise, and balances of trade of the various important countries of the world for the years 1931 and 1935 :—

Country	Date of Official Suspension of Gold Standard	Percentage of Depreciation	Index Numbers of Wholesale Prices Base 1929 = 100		Foreign Trade before Currency Depreciation or Exchange Control				Foreign Trade after Currency Depreciation or Exchange Control			
			1931	1935	Exports in millions 1931	Imports in millions 1931	Balance of Trade in millions + Favourable - Unfavourable able 1931	Exports in millions 1935	Imports in millions 1935	Balance of Trade in millions + Favourable - Unfavourable able 1935		
U.S.A.	March 6, 1933	40.94	70.6	83.9	\$ 2376	\$ 2083	+\$ 288	\$ 2244	\$ 2040	+\$ 204		
U.K.	Sept 21 1931	40	70.2	74.1	£ 384	£ 204	-£ 420	£ 422	£ 708	-£ 286		
France	June 1928 Sept 1936		80.0	54.0	F 30432	F 42204	-F 11772	F 15590	F 20945	-F 5355		
Canada	Oct 19 1931	30			\$ 648	\$ 824	+\$ 24	\$ 837	\$ 552	+\$ 285		
Japan	Dec 13 1931		69.6	81.4	Yen 1116	Yen 1212	-Yen 96	Yen 2455	Yen 2426	+Yen 29		
India	Sept 21 1931	21	68.1	64.5	Rs 1656	Rs 1356	+Rs 300	Rs 1571	Rs 1400	+Rs. 171		

Except India most of the countries in the previous table depreciated the external value of their currency standard by devaluation or exchange control as soon as the economic crisis of 1929-32 set in and international efforts to find a solution for the same failed. Column 2 shows the dates on which the various countries suspended the gold standard. Column 4 shows the index numbers of wholesale prices. A comparison of figures in these columns shows that after currency depreciation there was a definite improvement in the internal price levels in the case of U. S. A., United Kingdom, Canada and Japan. On the other hand in case of India we see that there was a constant fall in the index number of wholesale prices. Taking 1929 as the base year the price level in 1930 was 82'3, in 1931 it came down to 68'1, and in 1935 to 64'5. On account of this all productive industries in India and particularly agriculture badly suffered, and there was an all round fall of profits, incomes, salaries, and wages; and there was a good deal of under-employment and unemployment. Further a comparison of various figures in columns 5 and 6 shows that except India almost all the other important countries such as U. S. A., United Kingdom, France, Canada, Japan, etc., as compared to 1931 improved their positions in 1935 in international trade and commerce. There was a marked improvement in the balance of trade of these countries. On the other hand figures relating to India exhibit a very sad state of affairs.

If we compare our figures of 1935 with those of 1928-29 *i.e.*, before the 1929-32 crisis set in, we find that our exports fell down from Rs. 338 crores to Rs. 157 crores *i.e.*, a fall of about 53'6 per cent, while our imports had fallen from Rs. 251 crores to Rs. 140 crores *i.e.*, a fall of about 44'2 per cent. Thus we see that during that crisis not only our total foreign trade had fallen very heavily, but that our exports had fallen much more heavily than our imports, with the result that our net favourable balance of foreign trade had fallen from Rs. 87 crores nearly to the very low figure of Rs. 17 crores, while our foreign obligations on account of invisible imports

and Home Charges had remained almost the same.

The unprecedented heavy fall of prices of agricultural commodities unaccompanied by any reduction in the stipulated money payments of Indian agriculturists to their land lords and money lenders made them quite unable to meet even their expenses of production out of the money value of their produce. On the other hand owing to a heavy depreciation of the currency standards of many important countries of the world in terms of gold, the price of gold in those countries became higher than in India. Thus as a result of heavy losses in agricultural industry and an attraction of a rise of the price of gold, millions of small scattered past savings of the poor agriculturists in the form of small gold ornaments came out of their hoards and were sold in the market in the form of distress gold. The city bullion dealers as well found it a very profitable business to collect large quantities of gold from the interior and export it to foreign countries. The Government of India also found a point of relief in these gold exports for they enabled it to buy sterling bills to pay Home Charges, which in the absence of a heavy favourable balance of India's foreign trade could not be paid without lowering down the exchange rate to a very low figure. Thus gold exports from India during the period of economic crisis saved the Government of India from a very bad situation. The following table shows the net exports of gold from India from 1931 when England went off gold standard and when the economic crisis set in India completely —

Year	Net amount of gold exported. (Millions of fine ounces)	Value in crores of rupees
1931-32	7.73	57.98
1932-33	8.35	65.52
1933-34	6.70	57.05
1934-35	5.69	52.54
1935-36	4.02	37.36
1936-37	3.01	27.85
1937-38	1.77	16.33
1938-39	1.35	13.05
1939-40	3.16	34.67
Totals	41.78	362.35

Throughout the period of economic crisis as one country after another England, Norway, Sweden, Egypt, Japan, United States, Belgium, France, Holland, Switzerland, Italy, and Czecho-Slovakia depreciated or devalued their currency standards; India's balance of foreign trade suffered, the price-level inside the country fell down, trade, industry and agriculture experienced a depression, unemployment and under-employment increased, and exports of gold took to alarming figures. Consequently demand for a devaluation or depreciation of the rupee in terms of sterling was pressed hard on the Government of India. In 1933 there was formed a Currency League of India by some big businessmen and industrialists of the country to educate the public opinion against the continuation of 1s. 6d. exchange parity. When the Reserve Bank of India Bill was introduced in Legislative Assembly in September 1933, in that also there was a provision of 1s. 6d. exchange parity. When the Bill was under consideration of the Legislative Assembly, an amendment to it recommending lowering of the exchange parity was moved but was defeated.

From 1938 the question of devaluation of the rupee or the lowering of its sterling exchange parity took a political turn in India. In May of that year the Prime Ministers of all the provinces where Congress Party formed the Government resolved to secure the co-operation of all the Provincial Governments of the country to send a representation and press the Government of India to devalue the rupee. On June 6, 1938 the Government of India issued a communique stating therein that they were satisfied that the maintenance of 1s. 6d. exchange parity of the rupee was in the interests of India and that the sterling resources available in the hands of the Reserve Bank and the Government of India were over Rs. 160 crores, which were more than sufficient for the purpose.

On December 14, 1938 the Working Committee of the Indian National Congress passed the following resolution protesting against a continuation of 1s. 6d. exchange parity

and urging upon the Government of India to lower it to 1s. 4d. :—

“Since the fixation of the ratio at 1s 6d. to the rupee all trade interests in India and public bodies have protested that this measure is against the vital economic interests of India and have insistently demanded its revision. The Government of India have hitherto resisted all these attempts and last issued a communique on June 6, 1938, declaring that it did not intend to make any change in the ratio for the time being and in support of that declaration sought to rely merely on the instability and uncertainty during the period of readjustment which, according to them, was likely to cause greater loss to Indian interests than any corresponding gain from the change to a lower ratio. Since June last the balance of trade has turned more and more against India. The Committee are of opinion that the rate of 1s. 6d. to the rupee has hit hard the agriculturist of this country by lowering the price of agricultural commodities and given an undue and unfair advantage to imports into this country. The Working Committee is satisfied that the rate of 1s 6d. cannot any longer be maintained by large exports of gold which have been very injurious to the country. Matters have now reached a stage when the rate can only be maintained by a policy of contraction of currency and credit and by further depletion of the gold and sterling resources of India and particularly the Paper Currency Reserve. Those sterling resources have already been used up to an alarming extent and there is a danger of further serious depletion taking place if efforts continue to be made by the Government of India to maintain the present ratio. The Working Committee look upon such prospect with the utmost concern and anxiety. In view of this situation the Working Committee have come to the conclusion that the best interests of the country demand that efforts to maintain the present exchange level should henceforth cease and urge upon the Governor General-in-Council the necessity of taking immediate steps to lower the rate to 1s 4d. to the rupee.”

To refute the main arguments in the above resolution of the Working Committee of the Indian National Congress, on December 16, 1938 the Government of India issued an official communique in the following words:—

“The Government of India wish to make it clear that they have no intention of allowing a lowering of the present exchange value of the rupee. On the contrary, they intend to defend it by every means in their power and are confident of their entire ability to maintain it.

It is said that since their previous declaration of June 6, 1938, the balance of trade has turned more and more against India. The fact is that, in every month since June, the balance of trade, even excluding treasure, has been in favour of India and to an extent greater than in the corresponding month of the previous year.

It is said that the sterling resources of India, particularly those of the Paper Currency Reserve, have been used up to an alarming extent. The facts are that the assets of the Paper Currency Reserve were merged in those of the Reserve Bank in April 1935, and that the gold and sterling resources of the Bank are as high now as they were at the time of its inception and are in any event more than 50 per cent. of the total liabilities as opposed to a statutory requirement of 40 per cent. only. Moreover, since the inception of the Bank 60 crores of sterling debt have been repatriated.

It is said that the 1s. 6d. ratio has hit hard the agriculturist by lowering the price of agricultural commodities. The fact is that, since June last, the trend of the price index of the chief articles of export has been definitely upwards.

The Government of India are convinced that a lowering of the ratio in the existing international market conditions would produce no appreciable rise in what the cultivator can realise for his produce. They are equally convinced that it would produce an immediate rise in the cost of what he buys.

It would also seriously weaken the budgetary position of the Central Government and the larger Provincial Governments.

In fact, a lowering in the ratio would do no good to anybody except the moneyed and speculative interests who profit from conditions of uncertainty and disturbance or who secure an additional but unseen all round increase of $12\frac{1}{2}$ per cent in the protection afforded to them at the expense of the consumer

Altogether the Government of India have no doubt that it is their clear duty in the interests of India generally and the cultivator, in particular, to defend the present ratio to the utmost of their power. As already stated they have every belief in their ability to do this and they are confident that drastic measures of contraction will not be necessary, except to the extent that they are forced on them by the action of speculators who place their funds abroad in the hope of bringing them back at a profit. Incidentally, they are convinced that the exchange would be materially stronger today, were it not for the fact that there have been large movements of funds to the United Kingdom by these same speculative interests during the last year."

During the year 1939 till the commencement of the present war on September 3 the controversy relating to India's exchange parity continued to remain quite lively and spirited but after the outbreak of the war it lost all its force for in the first instance India began to export large quantities of war materials needed by the allied countries and secondly on account of a very rigid exchange control for which provision had immediately been made in the Defence of India Ordinance promulgated on the outbreak of the war. Exchange control regulations under the above Ordinance require exporters to make a declaration at the time of shipment that they would receive payment for their goods in a manner and within a time approved by the Reserve Bank which is the agent of the Government of India to enforce Exchange Control Regulations. The problem of exchange control we will study in a subsequent chapter.

Here one thing worth noticing is that Indian exchange left free to rise in response to heavy exports and favourable

balances of trade during the present war years must have risen very high, and thereby by checking exports and encouraging imports must have automatically corrected the present day very high internal price-level to a large extent. Under trade and exchange control and heavy purchases of sterling by the Reserve Bank of India the sterling exchange rate has remained more or less stationary all these five war years at 1s. 6d. per rupee—a state of affairs which is just opposite of what happened during the last Great War of 1914-18. The following table gives India's favourable balances of trade, Reserver Bank's purchases of sterling, and average rate of exchange in sterling purchases by the Reserve Bank during the past five years of the present war.

Year	Balance of Trade. (In crores of rupees)	Reserve Bank Purchase of Sterling (In crores of rupees)	Average Rate of Exchange in Sterling Purchases by Reserve Bank
1939-40	+78 02	86	1s. 5 ⁶ / ₈ d.
1940-41	+68 54	76	1s. 6d.
1941-42	+79 88	98	1s. 6d.
1942-43	+84 25	122	1s. 6d.
1943-44	+91 32	140	1s. 6d.

Questions

1. Write short notes on:—

- Over-valuation,
- Under-valuation, and
- Devaluation.

2. Describe briefly the arguments given by Babington Smith Currency Committee of 1919 in favour of fixing India's exchange rate at 2s. 4d. sterling, or 2s. gold.

3. Trace briefly the history of Indian exchange rate from 1919 to 1925, when the Hilton Young Currency Commission was appointed.

4. Describe briefly the main recommendations of the Hilton Young Currency Commission of 1925 relating to the exchange parity of India.

5 Describe briefly the main arguments advanced by Sir Purshottamdas Thakurdas in advocating a reversion to 1s 4d. exchange ratio in the Hilton Young Currency Commission Report of 1926.

6. Trace briefly the history of Indian exchange rate from 1525 to September 21, 1931.

7 What were the effects on Indian trade, industry and agriculture of Indian exchange ratio of 1s 6d and England's going off gold standard on September 21, 1931? Describe briefly

8. Describe briefly the causes that encouraged heavy exports of gold from India from 1931-32 to 1939-40.

9. Describe briefly the arguments advanced in December 1938 by the Working Committee of the Indian National Congress in favour of a reversion to 1s 4d exchange parity and the arguments of the Government of India in favour of maintaining exchange ratio at 1s 6d.

10 Describe briefly the factors that have helped the Government of India to maintain Indian exchange rate at 1s 6d. in spite of heavy favourable balances of trade of the country during the present war years.

CHAPTER XVIII. EXCHANGE PEGGING

Sometimes owing to a great depreciation in the intrinsic value of the standard money of a country either due to a fall of price in the world markets of the metal of the standard coin of that country or due to inconvertibility of its paper currency, the foreign exchange rate or the external exchange value of the monetary standard of that country tends to approach such a low level, that there is a danger of a great dislocation in the economic life of the country. When the exchange rate of a country thus becomes very unfavourable to it, the general price-level of both imported goods and those produced at home goes very high and all consumers suffer. Moreover on account of great depreciation of the country's standard the burden of all foreign payments including repayment of all previous debt contracts becomes very heavy. Such a state of affairs happened in India from 1873 onward owing to a heavy fall of gold price of the silver contents of the Indian rupee, and the exchange value of the rupee which was about 2s. in 1872 came down to about 1s 2d in 1892. In England during

he Great War of 1914-18 owing to very heavy payments to U. S. A. on account of large supplies of food, munitions and raw-materials from that country, the Dollar-Sterling exchange rate showed tendencies of a great weakness. Before that war Dollar-Sterling exchange rate was about \$ 4'86 = £ 1; but as war years rolled on, it came down as low as \$ 4'76 = £ 1 and showed tendencies of a further decline.

On an occasion like the above the currency authorities of a country may not leave the exchange rate of their standard money to be determined by the natural forces of the intrinsic value of their standard or by the condition of import and export of merchandise and specie, but may fix the country's par of exchange in terms of currency of another country at an artificial figure considered suitable, and take all possible steps to control the market rates of exchange within narrow limits from that parity by providing to the public the bills of that foreign country at a fixed ratio based on that artificial parity. Technically this is known as *exchange pegging*. By pegging its exchange rate in this manner in terms of currency of a foreign country, a country may control its foreign exchange rates with regard to all other countries of the world. After the fall of gold value of Indian silver rupee from 1873 onward the Indian currency authorities pegged Indian exchange rate, in 1898 at 1s. 4d. = Re. 1 in terms of English currency and from that date upto this time Indian exchange is working on a pegged system, though the rate has been changed from time to time according to the notions and convenience of the currency authorities in India. In England during 'the Great War of 1914-18 owing to heavy Dollar-Sterling exchange depreciation the English currency authorities pegged their exchange rate at \$ 4'76½ = £ 1.

Exchange pegging is an artificial device of maintaining the external value of a country's standard or its exchange rates at inflated figures, which otherwise would fall to very low figures as a result of the natural causes. It should be noted here that maintaining exchange rates at any pegged parity by any country is not possible unless the currency

authorities of that country somehow try to bring under their control sufficient quantities of the supplies of the foreign currency of that country in whose terms they peg the exchange rate of their country's standard, or control the demand of that foreign currency in their country. In India from 1893 onward this was managed by creating in England the Indian Gold Exchange Standard Reserve Fund and by providing Indian importers of British goods Sterling Reverse Council Bills at the rate of 1s 3½d per rupee in case the exchange rate showed tendencies of weakening and falling much below the pegged rate. On the other hand if at any time the exchange rate tried to go much above the fixed parity the Secretary of State for India offered on behalf of Government of India Council Bills at the rate of 1s 4½d per rupee. In this way upto the outbreak of the Great War of 1914-18 the Indian exchange rate was maintained at the pegged rate of 1s 4d.

During the Great War both owing to a great rise of the gold price and silver contents of the rupee and heavy exports of war materials and other goods from India the exchange rate of India could not be maintained at the old pegged rate of 1s 4d and the Indian currency authorities had to give up their control. In 1920 the Indian currency authorities again pegged the rupee sterling exchange rate, but this time at a parity of 2s 4d per rupee. In spite of great efforts this exchange parity could not be maintained even for a short period of time. In 1927 India again pegged her exchange rate in terms of sterling at the rate of 1s 6d per rupee and since then it is being maintained at the new parity. From April 1927 the old system of Secretary of State selling Council Bills at the upper specie point has been replaced by the system of Government of India purchase of sterling from Indian exporters by inviting tenders. Since the establishment of the Reserve Bank of India in 1935, the responsibility of maintaining Indian exchange at the pegged rate of 1s 6d has been entrusted to that Bank under Sections 40 and 41 of the Reserve Bank of India Act 1934.

In England during the Great War of 1914-18 the Dollar

Sterling exchange rate was pegged at \$ 4'76½ per pound and it was maintained at that rate by raising large quantities of dollar credits in America both by mortgaging and selling American and Canadian securities held by Englishmen and by the American Government raising loans in America for the British Government. Out of those funds dollar bills were sold by the English currency authorities to the importers of munitions and food materials in England at the rate of \$ 4'75½ per £ 1 so that they might pay their American creditors or exporters of those goods at that rate. By 1920 owing to heavy Great War expenditure, inflation of paper currency and steep depletion of gold reserves English currency conditions became so much worsened that England had to go off gold standard and Dollar-Sterling exchange rate could not be maintained at the pegged rate of \$ 4'76½ to a pound.

From the above facts it is obvious that exchange pegging can be used merely as an artificial device to prevent the exchange rate of a country from declining fast and that also only for a temporary period of time and not as a permanent currency policy or standard of any country as has unfortunately been practised in India since 1898. Even as a temporary measure of currency policy success of exchange pegging depends upon the ability of a country adopting it to secure sufficient quantities of foreign currency and regulate very strictly all kinds of demands of foreign currency, which in other words is technically known as the mechanism of exchange control,

Exchange Control

It has been emphasised before that for the continuance and proper development of the economic life of a country stability of its foreign exchange rates is a vital matter. In abnormal times like war, economic depression, or other national calamities the foreign exchange rates of a country tend to sink or rise to levels at which trading with other countries would become impossible and the entire national economy of the country would become extremely jeopardised. On such an

occasion it becomes essential for the currency authorities of the country to peg their exchange rate at a ratio considered suitable and take all steps to maintain the exchange rate at the pegged ratio by controlling all factors which create a demand for or a supply of foreign currencies through foreign bills. Thus exchange control in any country at any time comprises of all interferences by the monetary authorities of that country to maintain the exchange rate at the pegged ratio by influencing the demand and supply of foreign bills in the exchange market of the country *e. g.* :—

(1) *Restrictions on the import and export of merchandise* through tariffs, quotas and licences. As import and export of merchandise is the main cause of affecting the exchange rate, all foreign trade is regulated in a way which would be conducive to the maintenance of the pegged ratio. Ordinarily this is done through customs tariffs or imposition of import and export duties, but if they fail to bring the desired result all foreign trade may be subjected to quotas and licences which would insure the import and export of only such quantities of only such commodities and only to such countries which would not cause any serious disturbance to the country's exchange rate.

(2) *Restrictions on the import and export of specie* by tariffs or embargo. As effectiveness of the specie points of a country to maintain the pegged ratio depends upon the stocks of gold held by the currency authorities of the country its export from the country is prevented by heavy export duties or embargo so that the gold resources of the currency authorities may not fall very low and thereby threaten the stability of the exchange ratio.

(3) *Restrictions on the import and export of capital*. Dealings in international securities in the stock exchanges also create a demand for or a supply of foreign currencies in a country and thereby influence the exchange rates of the country. In a period of exchange control all these dealings are so restricted and regulated that it may be possible for the currency authorities of the country to maintain the fixed ratio of exchange.

(4) *Acquisition by the monetary authorities of the country foreign securities held by its nationals.* In a period of great demand of foreign currency and exchange weakness all foreign securities and credit balances held by the residents of a country may be acquired by the currency authorities of the country and by the mortgage or sale of those securities foreign currency may be secured and utilised for maintaining the pegged ratio by offering the foreign currency so acquired for very urgent demands on the country.

(5) *Freezing credit balances held by foreigners in the country.* In a period of exchange control in order to restrict transfer of funds from the country to other countries and thereby regulate the demand of foreign currencies, all credit balances held by foreigners inside the country may be frozen for a certain time considered suitable.

(6) *Acquisition of all available foreign exchange in a country by its monetary authorities.* In a period of exchange control in order to insure the maintenance of the pegged ratio, the currency authorities of a country may become the sole buyer and holder of all available supplies of foreign exchange or bills, and it may be made compulsory for all the people of the country to surrender to the currency authorities or its agents all their present and future stocks of foreign exchange. Thus all open market transactions in foreign bills are prohibited and generally the Central Bank of the country is the institution to which all foreign bills must be sold by the people at the official price or parity of exchange. This is done with a view to centralise and conserve all supplies of foreign currency and direct them to maintain the fixed exchange ratio

(7) *Rationing the available supplies of foreign exchange.* In a period of exchange control generally the currency authorities of a country become the sole proprietor of all available supplies of foreign exchange in the country and distribute it at the fixed parity only to such persons and for such purposes considered essential.

(8) *Entering into exchange clearing agreements with other countries which may have set up an exchange control machinery* Under these agreements the currency authorities of a country secure prompt payment for all the exports by the people of their country to such countries which at that time may be exercising an exchange control.

(9) *Setting up an Exchange Equalisation Fund* to control the speculative factors of foreign exchange In a country exercising exchange control at any time this institution may also be set up to form a part of the machinery of exchange control. At a latter stage in this book the organisation and working of such a fund has been discussed and the readers are requested to refer to those pages

Exchange Control in India.

Since the commencement of the present World War there has been set up in India an elaborate machinery of exchange control Provision for such a control of all dealings in India in foreign exchange, gold and securities had been made in part XIV of the Defence of India Rules issued under the Defence of India Act 1939. Under the rules the Reserve Bank of India has been authorised to administer the control, and to cope with the considerable work that it involves the Bank created in October 1939 a new Exchange Control Department By arrangement among the countries of the British Empire, for the purposes of exchange control the Empire is considered a single currency unit, allowing free transfers of funds therein but imposing parallel restrictions on conversions into outside currencies in each Empire country.

Rule 91 of Part XIV of the Defence of India rules prohibits the acquisition by residents in India of any foreign exchange either directly or indirectly, as also any dealings in foreign exchange or gold except with persons authorized by the Reserve Bank of India, but provides that transactions done by persons so authorized within the scope of their authority are not restricted It further provides that persons might acquire foreign exchange for certain approved purposes such

as for meeting reasonable business requirements in fulfilment of pre-war contracts and for reasonable travelling or personal expenses, but subject to the approval of the Reserve Bank. The first action taken by the Reserve Bank after promulgation of the Ordinance authorizing it to control foreign exchange was to issue an explanatory memorandum to the public advising them of the conditions under which the people of the country were permitted to transact business in foreign exchange. The Bank also announced that it would issue licences to deal in foreign exchange to all recognised exchange banks and also to any other scheduled bank which had in the past dealt in foreign exchange.

The terms and conditions under which the banks authorized to deal in foreign exchange are allowed to operate, and the purposes for which the general public are allowed to purchase foreign exchange from them have been notified by the Reserve Bank. They provide that remittances can be made freely from India to other countries within the sterling area, but a remittance to any country outside the sterling area can be made after the remitter completes an application form stating the purpose for which remittance is required. Remittances are divided into the following five categories :—

- (1) Payment of imports.
- (2) Petty private remittances.
- (3) Travelling expenses.
- (4) Other trade purposes (*e. g.*, freight, profits, royalties, etc.).
- (5) Capital remittances.

Authorized dealers are allowed to sell exchange to licensed importers of foreign goods provided the applicant undertakes to produce Customs Entry Forms as evidence of permission and actual import of goods. For petty private remittances and travelling expenses authorized dealers are permitted to sell exchange upto certain very small limits laid down, but applications for large amounts have to be referred to the Reserve Bank for prior approval. For travelling purposes

foreign exchange is generally refused except for urgent business reasons or to persons travelling on Government business. For payment of miscellaneous trade expenses such as freight profits, royalties, etc., certificates from Chartered Accountants or other suitable evidence has to be produced by the applicants for foreign exchange. Remittances of a capital nature are permitted only under exceptional circumstances and have to be approved by the Reserve Bank. Authorized dealers are forbidden to sell foreign exchange except to residents in India. Banks are permitted to enter into forward contracts of foreign exchange but are required to satisfy themselves that they are in cover of genuine trade transactions. Transactions in foreign currencies with others than banks authorized to deal in foreign exchange are prohibited. The regulations are designed to prevent any flight of capital and to make speculative or arbitrage operations in exchange impossible.

Dealings in gold locally are permitted, but exports of gold are permitted only to United Kingdom under licence. Licence for export of gold to U. S. A. are granted only to authorised dealers in foreign exchange provided they undertake to surrender the dollar proceeds of the gold shipped to the Reserve Bank of India. Imports of gold into India are also permitted under licence provided no expenditure of U. S. A. dollars is entailed. Acquisition of securities from any person not resident in India or the export of securities without the permission of the Reserve Bank is prohibited. There is general permission for the purchase of securities expressed payable in British Empire currencies in any place within the Empire sterling area, and licences are freely given for the export of rupee, sterling or other Empire currency securities to other parts of the Empire. Export of foreign securities for sale is permitted under licence only when an undertaking is given that the foreign exchange proceeds shall be surrendered to the foreign agents of an authorised exchange bank in India.

With the development of control it was found necessary to institute control of the proceeds of exports from India to

places outside the sterling area, but later on it was extended to nearly all countries in the world, and for this the bank has introduced an Export Control Scheme. The objects of this scheme are that the foreign exchange proceeds of exports are returned to India and not retained abroad and that exports are financed in certain specified ways. The scheme is worked through the Customs Department and the authorised banks by means of forms which the exporter has to complete stating the value of his shipment and his method of finance. One copy of this form is handed to the Customs, who do not permit exports to countries covered by the order without its production. The form is then forwarded to the Reserve Bank. The other copies of the form the exporter delivers to his bankers at the time of negotiation of his bills covering the export. These are also forwarded to the Reserve Bank, which checks up the forms with the original received from the Customs. All exports are thus accounted for.

An arrangement has been entered into with the Bank of England whereby banks authorised to deal in foreign exchange in India are permitted to sell either to the Bank of England or to the Reserve Bank of India on behalf of the Bank of England their surplus foreign currency and in the same way are permitted to purchase from the Bank of England with the approval of the Reserve Bank of India cover for their sales of foreign exchange to the general public for approved purposes. No restrictions are placed on banks dealing in foreign exchange with other banks in India and banks are not compelled to sell their surplus exchange to the Bank of England if they are able to dispose of it to an authorised dealer in foreign exchange in India, nor are they compelled to buy foreign exchange from the Bank of England if they are able to buy their requirements locally.

The Government of India has also appointed the Reserve Bank of India the licensing authority for persons taking money or jewellery out of the country. Upto a certain limit there is a general permission by the Reserve Bank to take out cash and jewellery, but above the prescribed limit

permission has to be secured from the Exchange Control Department of the Bank. In November 1940 the Government of India decided to acquire the U.S.A. dollar balances of residents in India and in March 1941 their holdings of certain American securities and all this was arranged by the Exchange Control Department of the Reserve Bank. In brief the Exchange Control Department of the Reserve Bank acts as licensing authority for dealings in foreign securities the export and import of gold and sovereigns and the export of money and *pari passu* besides regulating all dealings in foreign exchange. All these activities aim at restricting foreign remittances to the minimum and ensuring that the foreign exchange proceeds of exports and of holdings of gold and securities of nationals are made available to the country for the purchase of essential requirements from abroad during the present War period.

Exchange Equalisation Fund

The other name of this Fund is Exchange Equalisation Account. It is a small Government Department organised by any country to prevent excessive movements in its foreign exchanges. For the first time it was set up in England in April 1932 with assets of about £ 150 million in Treasury bills, increased in April 1933 by an additional sum of £ 200 million of Treasury bills and in June 1937 a further amount of £ 200 million was added to the Fund. A part of the fund is invested in the form of holdings of foreign currencies. Later on some of the other countries such as France U.S.A., etc., also set up similar funds. In 1932 it was found necessary by Britain to peg pound sterling against its upward movements. At such a time it was essential for the currency authorities of England to see that the country's holdings of foreign currencies were greater or less than the volume of sterling deposits held by foreigners in England. If the volume of foreign currency held by the country was greater than the amount of deposits held in the country by foreigners then the rate of foreign exchange was too low and must be allowed to rise. On the other hand if it was less than the rate was

too high and must be lowered. The work of Exchange Equalisation Fund was of acquiring foreign currencies in proportion to the increase of foreign balances in the country and reducing them in proportion to the decrease of foreign balances in the country without increasing or decreasing the volume of domestic currency as a counterpart. Thus the institution of Exchange Equalisation Fund made it possible for the currency authorities of Britain to prevent to some extent the short-term capital movements disturbing either her foreign exchanges or short-term money rates in the London Money Market. The Exchange Equalisation Fund of England is still in existence and the desirability of its retention as a permanent part of currency and exchange machinery of England is beyond doubt.¹

Questions

1. What is exchange pegging? What advantages can be secured through it? Describe briefly.
2. Describe briefly the circumstances in which India pegged her exchange rate at 1s. 4d. per rupee in the year 1898 and the machinery it set up for maintaining it.
3. Give your arguments in favour and against a system of pegged exchange of any country.
4. "From 1898 upto the present time India has been working on a system of pegged exchange." Prove the truth of this statement.
5. What is exchange control? What are the principal steps that have to be taken by the currency authorities of a country to control its exchange? Describe briefly.
6. Describe briefly the system of exchange control in India during the present war time.
7. What do you understand from Exchange Equalisation Fund? Describe briefly its object and organisation.

CHAPTER XIX

EFFECTS OF WAR ON INDIAN CURRENCY, CREDIT & EXCHANGE

War and Currency

Silver Rupees. There is perhaps no phase of Indian economic life which the present War has affected more seriously than her currency. As soon as War broke out there grew up in India a tendency to convert notes into silver rupees and hoard them. As in the early years of the War the Allies had reverses, this desire became intensified. With the fall of France in 1940 the demand for silver rupees in India became very great. In the beginning the Reserve Bank met the demand of conversion of notes into silver rupees without any restriction. But the demand became so big that the Reserve Bank's holding of silver rupees which was about Rs. 75'87 crores in the Issue Department of the Bank on September 1, 1939, fell down to the low figure of Rs. 35'1 crores in June 1940. According to Section 36 (2) of the Reserve Bank Act 1934, the Bank is required to hold at least Rs. 50 crores worth of silver rupees in its Issue Department. Thus as War proceeded the Bank found itself in a very embarrassing situation and convertibility of its notes became endangered.

On June 25, 1940 the Government of India declared that possession of rupee coin in excess of one's personal or business requirements was illegal. This had some effect, but to cope with the situation in July 1940 and 1941 the Government put into circulation one rupee notes and declared them to be equivalent of silver rupees for all purposes. In course of time the Government also declared all silver rupees of Queen Victoria, Edward VII, George V and George VI which contained $\frac{1}{12}$ silver as non-legal tender and from December 1940 replaced them by the present quaternary rupees which contain $\frac{1}{2}$ silver. Queen Victoria and Edward VII standard silver rupee coins were withdrawn from April 1, 1941 and

May 31, 1942 respectively, 'and of George V and George VI from May 1, 1943, though they continued to be accepted at the offices of the Reserve Bank of India upto November 1, 1943. It is pertinent to note here that during five years of the war of 1914-15 to 1918-19 the total absorption of rupee coins in India was about Rs. 110 crores, while during five years of the present war from 1939-40 to 1943-44 the total absorption of rupee coin and Government of India one-rupee notes since July 1940 has been about Rs. 119 crores. Further it should be noted that during 20 years before the present war broke out there was on an average a return of Rs. 653 crores worth of silver rupees from circulation to currency authorities, while in the very first year of the present war there was on the other hand a net absorption of additional Rs. 10'08 crores worth of silver rupees in circulation.

Small Coins. As soon as present war broke out there grew up in India a great demand of rupee coins, but when their possession in excess of one's personal or business requirements was made illegal there developed in the country a great demand of small coins. When people saw that they could not hold large quantities of silver rupees they began to hoard small coins. During the winter months of 1942 there was a great scarcity of all small coins and particularly of the pice, which on account of a sharp rise of the market price of copper almost disappeared from circulation. In November 1942 at the counters of the Bombay and Calcutta offices of the Reserve Bank of India there used to wait large queues of people to get change of rupees two at a time which the Bank allowed. There was consequently a great trouble in the country and in almost all big cities people began to use postage stamps as substitutes of small coins. Small coins began to sell at a premium and the public experienced great trouble in small transactions.

To meet the ugly situation so created first the Government made it an offence for the public to deal in small coins at any value other than their face or fiduciary values. Secondly by a Notification of April 17, 1943 possession of small coins

by any person in excess of one's genuine personal or business requirements was made illegal. These measures had some effect, but they were not enough. The people had no confidence in the ability of the currency authorities to provide adequate supplies of small coins, for from 1939-40 to 1941-42 on an average they could put into circulation small coins of only about Rs. 4 crores worth, and the composition also of all the small coins was so changed as to reduce their intrinsic values very low. From the past two years *i.e.* from 1942-43 the situation has eased very much for in these two years the Government has put into circulation a total amount of Rs. 30.1 crores worth of small coins.

It should be noted here that during five years of the Great War of 1914-15 to 1918-19 the total absorption of small coins in India was about Rs. 5 crores, while during the five years of the present war from 1939-40 to 1943-44 the total absorption of small coins has been Rs. 41.65 crores worth. Further it should be noted that during 20 years before the present war broke out there was on an average an absorption of small coins worth Rs. 35 lakhs per year, while in the very first year of the present war there was an absorption of Rs. 2.21 crores worth of small coins.

Table Showing Composition of Small Coins
Before & During War

Coin	Gross Weight in Grains Troy	Composition Before War in Grains Troy	Composition Changed During War in Grains Troy	Date of Introducing Change
Silver				
8 annas	20	82.5 silver and 7.5 alloy	45 silver and 45 alloy.	July 1940
4 annas	45	41.25 silver and 3.75 alloy	22.5 silver and 22.5 alloy.	July 1940
2 annas	22.5	20.625 silver and 1.875 alloy.	—	Suspended by Indian Coinage Amendment Act 1918.

Nickel					Suspended by Indian Coinage Amendment Act 1920. Coinage suspended from 1940-41
8 annas	120	Cupro-nickel alloy	Nickel-brass alloy of 79 o/o brass 20 o/o zinc and 1 o/o nickel		Introduced in Jan. 1942
4 annas	105				
2 annas	90				
1 anna	60				
1/2 annas	45				
Copper					
Pice	75 before war and 40 from 1943	Brass & Zinc.	Brass & Zinc.		
Half-Pice	37.5				
Pie Places	25				

Notes. Unlike coins, with the beginning of the present war for some time notes became unpopular. On September 1, 1939 i.e. two days before the present war broke out the total amount of notes in active circulation in India was Rs. 172'36 crores and for a short time after that date it was slightly less. But soon confidence was restored and from December 1939 the amount of notes in active circulation began to increase and the increase was particularly great after October 1940. Two points worth noting in this connection are that from July 1940 the Government of India put into circulation its own one rupee notes which for all purposes are to be treated as equivalent to rupee coins and from February 1943 the Reserve Bank of India has issued its notes of Rs. 2 each. Secondly by means of Government of India Notification No. 494—OR/40, dated the 25th June 1940, the Reserve Bank's obligation to issue rupee coin on demand in exchange of its notes has temporarily been suspended.

One feature of India's paper currency during the present war period is its huge increase in circulation. On September 1, 1939 the amount of notes in active circulation in India stood at Rs 172'35 crores, while at the close of the financial year 1943-44 it stood at Rs 882'49 crores i.e., a net increase of Rs. 710'13 crores or a rise of about 413 per cent. The huge increase in currency in circulation in India during

the present war and particularly of paper notes has brought with it an enormous rise of prices. The following table gives figures of absorption of notes and rupee coin in circulation and the index number of wholesale prices in India from 1938-39 to 1943-44.

Table of Currency Absorption & Wholesale Prices

Year	Increase or decrease in note circulation in crores of rupees	Increase or decrease of rupee coin in circulation in crores of rupees	Increase or decrease of notes and coins in circulation in crores of rupees.	Calcutta Index No of Wholesale Prices (July 1914=100)
1938-39	+ 2 98	- 12'60	- 9'62	95
1939-40	+ 49 54	+ 10 08	+ 59'53	115
1940-41	+ 19'11	+ 33 22	+ 52'33	119
1941-42	+ 152 40	+ 7'17	+ 159 57	144
1942-43	+ 262 33	+ 45 09	+ 303 42	211
1943-44	+ 238'91	+ 25'60	+ 264 51	317

One more feature of Indian paper currency system in which alarming changes have taken place during the present war is in the sterling securities held in the paper currency reserve of India. Just before the outbreak of the War sterling assets of the Reserve Bank were Rs 103 92 crores or 47'85 per cent. of the total liabilities of the Issue Department, while on December 29, 1944 they amounted to Rs. 948 75 crores or 92'90 per cent. of the total liabilities. According to Section 33 (2) of the Reserve Bank Act 1934 the sterling portion of the paper currency reserve of the Bank should at all times be at least 40 per cent of the total liabilities of the Issue Department. Of this 40 per cent. sterling portion of the reserve at least Rs. 40 crores should consist of gold coin and gold bullion and the rest may consist of sterling securities. During the present war though the total issue of notes from the Issue Department has increased enormously i.e. from Rs. 217 18 crores on September 1, 1939 to Rs 1021'26 crores on December 29, 1944; and the sterling portion of the reserve has also increased much i.e., from Rs 103'92 crores on September

1, 1939 to Rs. 948'75 crores on December 29, 1944, the amount of gold coin and bullion in that portion of the reserve has throughout remained Rs. 44'42 crores though sterling securities during the same period have increased from Rs. 59'50 crores to Rs. 904'33 crores. There is no doubt that this position is in accordance with the Reserve Bank Act 1934 or the present Indian paper currency law, yet investment of such a huge amount of the paper currency reserve of a country in the securities of a single foreign country cannot be regarded as a healthy or sound management of the paper currency system of that country, and the present position in India can be tolerated only as a war emergency measure.

War & Credit

With the declaration of the present war for some time there was a set-back in the credit conditions of India. Most of the banks of the country had to face heavy withdrawals by nervous depositors. Before the war commenced *i.e.* on September 1, 1939 the total deposits in banks included in the Second Schedule to the Reserve Bank of India Act amounted to Rs. 236'6 crores and within a week *i.e.* on September 8, 1939 they showed a decline of Rs. 5 crores. The panic caused by the out-break of hostilities soon declined and deposits began to increase and on March 29, 1940 they stood at Rs. 259'26 crores. Then again from May 1940 due to Allies reverses in war bank deposits began to decline and the total deposits fell heavily from Rs. 263 crores at the beginning of May 1940 to Rs. 241'5 crores at the end of June 1940. Then declaration of war against Japan in December 1941 and Japan's quick victories in the East again brought a heavy run of customers of banks for withdrawals, but all these were only short lived passing phases and public confidence which became shaken from time to time has not only restored but has definitely strengthened and improved and on June 2, 1944 the total deposits of people in banks included in the Second Schedule to the Reserve Bank of India stood at the high figure of Rs. 729'97 crores *i.e.* a total increase of Rs. 493'37 crores or of about 208 per cent. over the pre-War figure. What is true with regard

to deposits in the case of Scheduled Banks applies very aptly also to non-Scheduled Banks of the country. Among deposits it is worthy of noting that demand deposits have increased much more rapidly than time deposits.

The heavy increase in bank deposits during the present war is mostly due to huge profits made by businessmen particularly suppliers of war-materials and the excessive inflation of paper currency. Another feature of present war affecting bank deposits worth noting is a heavy concentration of deposits of the people in only a few old big banks of the country instead of being evenly distributed and scattered over all the banks of the country. During the war-period most of the deposits have localised in the Imperial Bank of India, the Exchange Banks and the big five Indian Joint Stock Banks namely the Central Bank of India, the Bank of India, the Allahabad Bank, the Bank of Baroda and the Punjab National Bank. Besides bank deposits the present war period has also witnessed a very large increase in the total cheque clearings at the various Bankers' Clearing Houses of India. In 1938-39 these total clearings were of Rs. 1929 crores whereas in 1943-44 they reached the high figure of Rs. 4349 crores. During the present war the public credit in India has also increased very much. Though on account of repatriation the sterling debt of the Government of India has decreased, but the rupee debt has increased much more and there is a net increase of several hundred crores of rupees in the public debt of India. Throughout these past five years of war the Government of India has raised from time to time several short and long period loans e.g. Three-year Interest-free Defence Bonds; 3 % Six-year Defence Bonds; Ten year Defence Savings Certificates; 3 % Second, Third & Fourth Defence Loans; Twelve-year National Savings Certificates; etc.

Unlike the Great War of 1914-18 one very remarkable feature of the present war is the successful maintenance of India's Bank Rate at the fixed rate of 3½ per cent. per annum and cheap money conditions throughout these 5½ years. There

is no doubt that for such a state of things to a great extent the cheap money policy of the Government of India is responsible for owing to very heavy war expenditure inspite of unprecedented increase of taxes the Government has been resorting to borrowing from the public at cheap rates. The Government has been financing industries producing war-materials directly and the industries as well have been making big profits. Consequently during the present war industries have more or less been independent of bank credits and have compelled banks to maintain low rates of interests of their loans advances and deposits. In the last Great War there was a sharp rise in the Bank Rate and along with it in all other rates of interest in India, whereas during the present war general money conditions have all along remained easy. On account of war almost in the whole of Europe and in the Pacific and shipping shortage, during the present war India has lost most of its export trade and consequently since 1940 the seasonal demand of short period credits which was a normal feature of the Indian Money Market before the war has disappeared and cheap money conditions prevail almost throughout the year.

One more point worth noting in this connection is the great expansion of institutions whose profession is to deal in credit *i.e.* banks during the present war period. There is no doubt that even during the last Great War there was an increase in the number of banks and banking offices in India, but during the present war there has been a fabulous increase in these figures. Almost every other day we see in papers the news of the floatation of a new bank or the establishment of a new bank office at some or the other place in India. The slow growth of banking during the last Great War was perhaps due to the fact that immediately before that war India had witnessed a serious banking crisis in which many banks of the country had failed. Unlike that the immense profits of businessmen during the present war, the need of more banks due to war conditions and Government policy—all have combined to increase the number of banks

and their offices during the present war. On September 1, 1939 the total number of Scheduled Banks and their branches in India were about 55 and 1200 respectively. On December 31, 1944 their totals had become about 80 and 2000 respectively. What is true with regard to Scheduled Banks aptly applies also to all Scheduled Banks. They have also established many head and branch offices. It is estimated that at present there are about 1400 banking companies in the country. There is no reason to get alarmed at the increasing number of floatation of banks during the war, provided they are properly and soundly managed, and in this connection the recent tendency of banks to raise their paid-up capitals is a very healthy sign.

War & Foreign Exchange

Of all the problems of currency foreign exchange is one which is most difficult to manage properly during abnormal times like war. Consequently as soon as present war broke out, besides other important issues, foreign exchange was one which attracted the attention of the Government of India immediately. As has already been mentioned before the first thing that the Government of India did on the commencement of the war was the introduction and enforcement of a system of exchange control. As war years rolled on and fresh difficulties were experienced the exchange control system was more elaborated and perfected. The result of all these measures has been a remarkable maintenance of India's foreign exchange rate at the pegged rate of 1s 6d. per rupee during all these five years of the present war from 1939 to 1944. This is very much different from what India experienced during the last Great War of 1914-18. In that war in 1914 when war had commenced the Indian exchange rate was 1s 4d, but as war had proceeded as a result of heavy exports of various kinds of goods and fall of imports, the Indian exchange rate had begun to rise sharply and in 1918 when that war had come to an end the Indian exchange rate stood at about 2s. per rupee. In the present war in spite of very heavy exports of visible and invisible goods

from India, the Indian exchange rate has throughout been about 1s 6d, for that is the rate at which on an average the Reserve Bank of India has been able to purchase sterling from 1939 to 1944. For more information read the topic 'Exchange Control in India' Chapter XVIII, page 322.

Questions

1. Describe briefly the effects of the present World War on the use of rupee coins in India.
2. What circumstances led to the scarcity of small coins in circulation in India during the present World War and what steps have been taken to ameliorate the situation? Describe briefly.
3. What great changes have taken place in the paper currency system of India during the present World War? Describe briefly.
4. What do you understand from Reserve Bank of India's sterling balance in England? What has been the effect of the present World War on that? Describe briefly.
5. Describe briefly the effects of the present World War on the credit structure and development in India.
6. Describe clearly the circumstances which have enabled the Reserve Bank of India to maintain its Bank Rate at 3 per cent. during the present World War.
7. Describe briefly the effects of the present World War on Indian exchange rate and the machinery of its maintenance.
8. Why is it that unlike the Great War of 1914-18 the Indian exchange rate during the present World War has remained stationary at 1s. 6d. per rupee? Explain fully.

CHAPTER XX

POST-WAR RECONSTRUCTION

Monetary Standard

In a volume of this type it is neither desirable nor possible to deal with the various problems of post-war reconstruction; but it will not be out of place to mention here some of the problems of Indian currency and exchange, which are either the heritage of past history, or have cropped up as a result of the various emergency measures, which have been adopted during the present war period and which the post-war India shall have to solve suitably in order to ensure the economic

stability and progress of the country. The first of these problems shall be 'India's standard.' India adopted a sterling exchange standard system at 16 6d per rupee since the Indian currency Act 1927. On September 21, 1931 England went off gold standard and so also Rupee linked with Sterling lost its connection with gold. In July 1932 England though off gold standard brought her currency under a system of management. Consequently from that date upto the beginning of the present World War Indian standard was a managed paper sterling exchange standard. Since the commencement of the present war on September 3, 1939 there has been enforced in India and England a system of exchange control with a number of restrictions on the convertibility of rupee into sterling and of sterling into rupee. At present during war such a state of affairs is going on as a war emergency measure; but soon after war the first question that shall arise would be 'can India go on with the present monetary standard, rupee ratio and exchange control and even if they be possible would that be in the interest of India?' 74

The history of Indian monetary standard since 1835 upto the present time clearly shows that it has been a series of unsuccessful currency experiments and the various standards adopted from time to time served only temporarily and miserably failed whenever opportunity came to put them to a severe test. The silver standard of India failed after 1873 mainly on account of the fall of the gold price of silver due to larger produce of silver from silver mines and abandoning of bimetallicism and adopting gold monometallicism by most of the countries of the world. The gold exchange standard adopted in 1898 failed during the old Great War 1914-18 and post-war years mainly because it entailed a responsibility on the currency authorities of India to convert domestic currency into gold exchange in unlimited quantities on the basis of a small Gold Exchange Standard Reserve Fund, while in case of a serious adverse balance of trade could not suffice to maintain exchange and gold value of the Indian standard. Secondly the responsibility to convert foreign

exchange into silver rupee coins in unlimited quantities was a very risky undertaking, for if at any time the gold price of silver rose very high as actually happened in 1919-20, foreign exchange could not be converted into costlier silver rupees without the currency authority suffering a heavy loss. ✓

The sterling exchange standard adopted in 1927 proved to be a very artificial system particularly after September 21, 1931, when England went off gold standard. Though formally the system or the standard has not failed since its adoption, yet the slavishness and hopelessness of the system have amply been proved both during the world economic depression of 1929-33 and the present war period. The Government of India themselves recognised the unsuitability of this standard, when in the preamble of the Reserve Bank of India Bill 1934 they admitted that at some future opportune time the question of India's proper monetary standard shall have to be considered. During the period of that economic depression, mainly it was India's currency standard which was responsible for the over-valuation of the rupee particularly in terms of sterling, and it was on account of that till the outbreak of the present war India lost very heavily in her economic progress and loss of gold through huge exports. Even during these war years this extremely heavy inflation of Indian paper currency unaccompanied by any rise in the Bank Rate has been a possibility due to the extreme artificiality of the Indian standard. What is India's present standard? It is rupee. What is rupee? It is a note printed on paper or token silver and its value is fixed at a certain rate into the inconvertible paper currency of another country i.e. sterling. This is why the present Indian standard commands little confidence and an extremely low purchasing power.

After war the Indian monetary standard must be changed in order to make it capable of resisting all possible manipulations in it and thereby secure a reasonable standard of stability in its internal and external values. Rupee has been the monetary standard of India from a

MONEY CREDIT AND FOREIGN EXCHANGE

very long time and people are accustomed to use that name for India's standard money. Consequently rupee should continue as the unlimited legal tender standard money of India and for circulation in the country may consist of notes and quaternary silver coins as at present. For maintaining its external value at a stable rate the rupee must be delinked from sterling the present exchange control must be removed as soon as possible and the value of the rupee must be fixed in terms of gold as recommended by the Hilton Young Currency Commission of 1925. The Indian currency authorities should statutorily promise to give gold in exchange of rupees and rupees in exchange of gold at a fixed rate for all purposes and in unlimited quantities i.e. India should adopt a gold bullion standard.

In the modern world gold is the basis of currencies of almost all the countries of the world. During the present war there are several moves to set up an international monetary standard in the post war period. In all the plans prepared in that connection namely the bancor international monetary standard recommended in the English Plan the unitas proposed in the American Plan and unit suggested in the Canadian Plan the provision is that the international monetary standard whatever it may be shall be equivalent to a defined quantity of gold. Consequently fixing the value of the rupee in terms of gold at a certain rate under gold bullion standard shall enable the country to maintain the external value of her standard in terms of the international standard and through that in terms of currencies of almost all other gold standard countries at stable rates. Such a standard shall not only be stable, simple and economical but shall command enough of confidence for it shall not be capable of such huge and serious manipulations which the gold and sterling exchange standards have been in the past.

After standard the next question that shall have to be decided would be the ratio of the rupee with gold or the statutory gold equivalent of the rupee. In this connection it must be remembered that for the proper economic development of a

country in modern times, when the different countries of the world are so closely connected with each other in their trade and credit relations, it is essential that the external value of the monetary standard of a country should neither be over-valued nor under-valued. It should have a normal value, which would permit the differential economic advantages and disadvantages possessed by the country to play their full part in the relation of the price-levels of the country as against other countries of the world. The rate should cause no undue strain either on the country's balance of payments or on her export industries, and in all its dealings with the other countries of the world there should be a reflection of the basic economic conditions of the country.

Now the question that arises is what ratio of rupee with gold can be regarded as the rupee's normal value which should be fixed as the rupee ratio with gold after war when the right opportunity offers itself. In this connection it must be remembered that the problems of re-payment of huge international loans raised during war, reparations, and adjustments of trade and industries from war-time conditions to peace-time conditions are bound to cause a great confusion in international monetary and trade relations in the early post-war years. Consequently from this very time when war has not come to an end, it is not possible to decide any ratio of Indian rupee with gold as the proper permanent post-war ratio of Indian monetary standard. When war comes to an end Indian currency authorities should wait and watch the developments of international trade and monetary systems and finding a suitable time should fix a proper ratio with gold. The same should be India's policy with regard to her joining any scheme of an international monetary fund for the clearance of international payments, proposed to be set up after war by the Allies. The three schemes proposed as they stand at present do not give any hope that if any international monetary organisation is set up in post-war years under any of them and India joins it, she will have an adequate weight in its organisation and management. Consequently India should not act in a haste in this respect and should join any such

organisation only if she finds that the advantages of joining would be substantial and that the terms of her admission would be quite honourable. In this connection it must be noted that if Indian economic interests are to remain properly safe guarded in any international monetary plan, India must have an opportunity of joining it as an independent country and not merely as a satellite subordinate to some imperial country.

• Paper Currency Reserve

Besides monetary standard and its exact ratio with gold, another important currency problem which post-war India shall have to consider seriously and decide shall be India's paper currency system *i.e.*, the constitution of the Indian paper currency reserve and the huge amount of sterling securities which have become a part of that reserve during the present war. At present according to Section 33 sub-Section (1) of the Reserve Bank Act 1934, the Reserve Bank is required to maintain a reserve of 100 per cent. behind its issue of notes or paper currency. According to sub-Section (2) of the above Section of the total amount of the reserve not less than two fifths or 40 per cent. must consist of gold coin, gold bullion or sterling securities, provided that the amount of gold coin and gold bullion shall not at any time be less than forty crores of rupees in value. The remainder of the reserve *i.e.*, three fifths or 60 per cent. shall be held in rupee coin and rupee securities.

There is no doubt that the present statutory position of the paper currency reserve to be maintained by the Reserve Bank has enabled the Indian paper currency system to be very elastic to meet the varying credit requirements of the country and control its money market. But as in the sterling portion of the paper currency reserve the minimum limit of gold coin and gold bullion to be held is fixed at a certain figure say Rs. 40 crores irrespective of the total amount of issue of notes and as the limit of two fifths or 40 per cent. of the sterling portion of the paper currency reserve is the minimum, at present legally there is a provision of an issue of huge amounts of

notes or paper currency and keep in the reserve gold coin and gold bullion of only Rs. 40 crores and the entire rest in the form of sterling securities. This is a very defective position. So long as the total issue of notes is not big say it is hundred or two hundred crores of rupees and the amount invested in sterling securities is at the most Rs. 60 crores, it is not a serious situation. But if at any time like the present war period the total issue of notes becomes a huge amount say Rs. 1021 crores and of this Rs. 904 crores or 88.5 per cent. is invested in the sterling securities in a foreign country, the situation is really alarming.

Notes or paper money is a currency of domestic circulation in every country. Consequently its reserve to ensure its convertibility should be maintained within the country. In India unfortunately the standard adopted is the sterling exchange standard and as such ultimately all notes are convertible into sterling. Hence, there is a provision that 40 per cent. of the paper currency reserve should consist of gold coin, gold bullion and sterling securities. If the Indian standard is changed to a gold bullion standard, there is no doubt that the present provision of sterling securities in the Indian paper currency reserve shall be substantially altered. Even if the Indian standard was a sterling exchange standard the rules relating to the paper currency reserve in the Reserve Bank Act 1934 should not have provided such a serious loophole for an indefinite expansion of sterling securities in the paper currency reserve, for it is possible that at a time when convertibility of Indian notes be demanded on a large scale it may not be possible for the Reserve Bank to realise its sterling securities and offer the proceeds to convert its notes and meet its statutory obligation. After war the Indian monetary standard must be changed into a full-fledged gold bullion standard and the minimum limit of the metallic portion of the paper currency reserve should ordinarily be fixed at 40 per cent., and this whole 40 per cent. should consist of gold bullion. This will allow a suitable elasticity to the paper currency system of the country and at the same

time shall act as a sufficient deterrent to any abnormal inflation or deflation of paper currency.

Sterling Balances

It has been mentioned before that the present regulations relating to the issue of paper currency in India by the Reserve Bank and maintenance of the paper currency reserve provide for an indefinite expansion of the holding of sterling securities in that reserve. Before the out-break of the present war the Reserve Bank of India had a holding of Rs 59.5 crores in sterling securities in its paper currency reserve. During the past five years of war this holding of the Reserve Bank has increased to Rs 904.33 crores or an increase of about 1407 per cent. The main reason of this very heavy increase in the sterling holdings of the Reserve Bank has been the policy followed by the Allies mainly England and U S A to procure war and other materials from India during the above period. For Allies purchases in India the Reserve Bank provides funds in India in the form of its notes and for this it receives payment in England in the form of sterling securities. Chiefly for this reason in India paper currency in circulation has become extremely inflated and Reserve Bank's holding of sterling securities in England has tremendously increased, and as yet there is no end to their expansions. These are also very disquieting rather alarming features of Indian currency at present, and the post-war years shall have to find a satisfactory solution of these.

One thing which deserves a weighty consideration in connection with the above sterling balances and their realization is that though they have accumulated as a result of Allies policy of purchase in India, yet they are the outcome of very heavy sacrifices made by the Indian people in their consumption. During all these war years India has denied or restricted for her people the consumption of numerous articles even by lowering down their standard of living to the verge of starvation, and has provided those articles for Allies use in war against the above sterling balances. Consequently after war when the question of repatriation of the sterling

balances comes, it is essential to see that that benefits the country to the utmost possible extent. This means that India should get them back without any depreciation of their value. For this it would be necessary that the sterling balances be freely convertible into the currencies of other countries of the world particularly dollar.

Secondly the getting back of the sterling balances should not mean the dumping of cheap consumers' goods in India during the post-war period of economic depression, thereby harming Indian industries by throwing them back to the pre-war position or thwarting their future progress. The realization of these balances should ensure continuity and progress of trade and industries in the country, thereby maintaining and encouraging employment and elevating the extremely low standard of living of the great mass of people. For this it would be well, that whatever be the scheme of realization of these balances, it must provide that most of the repatriation would be in the form of capital goods of real value, which would foster Indian industries. The Reserve Bank of India also should try to realise a suitable portion of these balances by importing gold into the country in order to introduce the gold bullion standard in the currency system of the country at an opportune time.

Further it must be noted that if any international monetary organisation is set up in the post-war period, India should see that that organisation would help her in realising her sterling balances according to the above objectives before she joins that organisation as a member. The American Plan of an international monetary organisation named as the United and Associated Nations Stabilisation Fund contains a provision for the realisation by the member countries of the abnormal foreign balances accumulated during the war. Before India joins that or any other international monetary organisation that may be established, India must see that it would help her in achieving her aims and furthering the true economic interests of the country.

Questions

- 1 Name the present monetary standard of India. Point out its defects and suggest a suitable currency standard, which India should adopt in the post war period.
- 2 What is the most important defect in the present regulations relating to the paper currency reserve of India? How can that be removed? Explain briefly.
- 3 What do you understand from the present war time sterling balances of India? How have they accumulated to such a great extent? How can they be best utilised by India in the post war period? Describe briefly.
- 4 Describe briefly some of the important present currency problems of India which she will have to solve satisfactorily in the post-war period.
- 5 Describe briefly the policy India should adopt in joining any international monetary organisation which may be set up in the post-war period.

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